APPLICATION OF ACCOUNTING STANDARDS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

▪ Understand the provisions of the Accounting Standards specified in the syllabus

▪ Solve the practical problems based on application of Accounting Standards
CHAPTER OVERVIEW

**Practical Application of**
- AS 7: Construction Contracts
- AS 9: Revenue Recognition
- AS 14 (Revised): Accounting for Amalgamations
- AS 18: Related Party Disclosures
- AS 19: Leases
- AS 20: Earnings Per Share
- AS 24: Discontinuing Operations
- AS 26: Intangible Assets

**Note:** The Students are advised to refer the bare Text of the Accounting Standards given in the book of Accounting Pronouncements while studying this Chapter.

1. **INTRODUCTION**

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The Accounting Standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements. Good financial reporting not only promotes healthy financial markets, it also helps to reduce the cost of capital because investors can have faith in financial reports and consequently perceive lesser risks. You must have already studied the concept, objectives, benefits and limitations, applicability and compliance of Accounting Standards, in detail, in Chapter 3 of “Accounting” Intermediate Course Study Material – Group I. We should discuss the Accounting Standards (specified in the syllabus) in this chapter taking individual standard in detail.
2. OVERVIEW OF THE ACCOUNTING STANDARDS

2.1 CONSTRUCTION CONTRACTS (AS 7)

Accounting Standard 7 prescribes the principles of accounting for construction contracts in the financial statements of contractors. The focus of the standard is on principles of revenue recognition by the contractors.

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

In a **fixed price contract**, the price is agreed as fixed sum or a fixed rate per unit of output. In some cases, the contract may require the customer to pay additional sums to compensate the contractor against cost escalations.

A cost plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

**Percentage Completion Method**

Construction contracts are mostly long term, i.e. they take more than one accounting year to complete. This means, the final outcome (profit/ loss) of a construction contract can be determined only after a number of years from the year of commencement of construction are over. It is nevertheless possible to recognise revenue annually in proportion of progress of work to be matched with
corresponding construction costs incurred in that year. This method of accounting, called the stage of completion method (percentage completion method), provides useful information on the extent of contract activity and performance during an accounting period.

The percentage completion method may suffer from a serious drawback viz. anticipation of profit. Since the method recognises revenue pending final outcome of a contract is known, it is possible that an enterprise may distribute dividend based on reported profit of a year, while final result is loss. To avoid such possibilities, percentage completion method should be used with caution. AS 7 prescribes that the percentage completion method should not be used unless it is possible to make a reasonable estimate of the final outcome of the contract. Also, AS 7 provides that whenever total contract cost is expected to exceed the total contract revenue, the loss should be recognised as an expense immediately.

As per AS 7, the outcome of fixed price contracts can be estimated reliably when all the following conditions are satisfied:

(i) total contract revenue can be measured reliably;
(ii) it is probable that the economic benefits associated with the contract will flow to the enterprise;
(iii) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
(iv) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

The outcome of a cost plus contract can be estimated reliably when all the following conditions are satisfied:

(i) it is probable that the economic benefits associated with the contract will flow to the enterprise; and
(ii) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

Example 1 (The percentage completion method)

X Ltd. commenced a construction contract on 01/04/13. The fixed contract price agreed was ₹ 2,00,000. The company incurred ₹ 81,000 in 2013-14 for 45% work
and received ₹79,000 as progress payment from the customer. The cost incurred in 2014-15 was ₹89,000 to complete the rest of work.

**Solution**

**Profit & Loss Account**

<table>
<thead>
<tr>
<th>Year</th>
<th>₹ 000</th>
<th>Year</th>
<th>₹ 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013-14</td>
<td>To Construction</td>
<td>2013-14</td>
<td>By Contract Price</td>
</tr>
<tr>
<td></td>
<td>Costs (for 45%</td>
<td></td>
<td>(45% of Contract Price)</td>
</tr>
<tr>
<td></td>
<td>work)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Net profit</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(for 45% work)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>81</td>
<td></td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>costs (for 55%</td>
<td></td>
<td>(55% of Contract Price)</td>
</tr>
<tr>
<td></td>
<td>work)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>89</td>
<td></td>
<td>110</td>
</tr>
<tr>
<td></td>
<td>90</td>
<td></td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>21</td>
<td></td>
<td>21</td>
</tr>
<tr>
<td></td>
<td>110</td>
<td></td>
<td>110</td>
</tr>
</tbody>
</table>

**Customer Account**

<table>
<thead>
<tr>
<th>Year</th>
<th>₹ 000</th>
<th>Year</th>
<th>₹ 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013-14</td>
<td>To Contract Price</td>
<td>2013-14</td>
<td>By Bank</td>
</tr>
<tr>
<td></td>
<td>90</td>
<td></td>
<td>By Balance c/d</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>90</td>
<td></td>
<td>90</td>
</tr>
<tr>
<td>2014-15</td>
<td>To Balance b/d</td>
<td>2014-15</td>
<td>By Bank</td>
</tr>
<tr>
<td></td>
<td>11</td>
<td></td>
<td>121</td>
</tr>
<tr>
<td></td>
<td>110</td>
<td></td>
<td>121</td>
</tr>
<tr>
<td></td>
<td>121</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

AS 7 provides that the percentage completion method should not be applied if the outcome of a construction contract cannot be estimated reliably. In such cases:

(a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and

(b) contract costs should be recognised as an expense in the period in which they are incurred.
An expected loss on the construction contract should however be recognised as an expense immediately.

When the uncertainties that prevented the outcome of the contract being estimated reliably cease to exist, revenue and expenses associated with the construction contract should be recognised by the percentage completion method.

**Example 2**

*X Ltd. commenced a construction contract on 01/04/13. The contract price agreed was reimbursable cost plus 20%. The company incurred ₹1,00,000 in 2013-14, of which ₹90,000 is reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at ₹5,000. The other costs to complete the contract could not be estimated reliably.*

*The Profit & Loss A/c extract of X Ltd. for 2013-14 is shown below:*

**Profit & Loss Account**

<table>
<thead>
<tr>
<th></th>
<th>₹ 000</th>
<th></th>
<th>₹ 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Construction Costs</td>
<td>100</td>
<td>By Contract Price</td>
<td>90</td>
</tr>
<tr>
<td>To Provision for loss</td>
<td>5</td>
<td>By Net loss</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>105</td>
<td></td>
<td>105</td>
</tr>
</tbody>
</table>

**Treatment of Costs Relating to Future Activity**

Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. The contract costs that relate to future activity on the contract are however recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

**Uncollectable Contract Revenue**

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.
Stage of Completion

The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

(a) the proportion that contract costs incurred for work performed up to the reporting date bear to the estimated total contract costs; or

(b) surveys of work performed; or

(c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

Example 3

Show Profit & Loss A/c (Extract) in books of a contractor in respect of the following data.

<table>
<thead>
<tr>
<th></th>
<th>₹ 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract price (Fixed)</td>
<td>600</td>
</tr>
<tr>
<td>Cost incurred to date</td>
<td>390</td>
</tr>
<tr>
<td>Estimated cost to complete</td>
<td>260</td>
</tr>
</tbody>
</table>

Solution

<table>
<thead>
<tr>
<th></th>
<th>₹ 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Cost incurred to date</td>
<td>390</td>
</tr>
<tr>
<td>B. Estimate of cost to completion</td>
<td>260</td>
</tr>
<tr>
<td>C. Estimated total cost</td>
<td>650</td>
</tr>
<tr>
<td>D. Degree of completion (A/C)</td>
<td>60%</td>
</tr>
<tr>
<td>E. Revenue Recognised (60% of 600)</td>
<td>360</td>
</tr>
<tr>
<td>Total foreseeable loss (650 – 600)</td>
<td>50</td>
</tr>
<tr>
<td>Less: Loss for current year (E – A)</td>
<td>(30)</td>
</tr>
<tr>
<td>Expected loss to be recognised immediately</td>
<td>20</td>
</tr>
</tbody>
</table>

Profit & Loss A/c

<table>
<thead>
<tr>
<th></th>
<th>₹</th>
<th></th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Construction costs</td>
<td>390</td>
<td>By Contract Price</td>
<td>360</td>
</tr>
</tbody>
</table>
Combining and Segmenting Construction Contracts

A contractor may undertake a number of contracts. The standard identifies certain cases where for the purposes of accounting, (i) More than one contract can be taken as one and (ii) a single contract can be taken as to comprise of more than one contract.

(a) When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

(i) separate proposals have been submitted for each asset;
(ii) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
(iii) the costs and revenues of each asset can be identified.

(b) A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

(i) the group of contracts is negotiated as a single package;
(ii) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
(iii) the contracts are performed concurrently or in a continuous sequence.

(c) A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

(i) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
(ii) the price of the asset is negotiated without regard to the original contract price.

Example 4

Mr. Shyam, a construction contractor undertakes the construction of an industrial complex. He has separate proposals raised for each unit to be constructed in the industrial complex. Since each unit is subject to separate
negotiation, he is able to identify the costs and revenues attributable to each unit. Should Mr. Shyam treat construction of each unit as a separate construction contract according to AS 7?

Solution

As per AS 7 ‘Construction Contracts’, when a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified.

Therefore, Mr. Shyam is required to treat construction of each unit as a separate construction contract.

Contract Revenue and Costs

(a) Contract revenue should comprise:

(i) the initial amount of revenue agreed in the contract; and

(ii) variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they are capable of being reliably measured.

(b) Contract costs should comprise:

(i) costs that relate directly to the specific contract;

(ii) costs that are attributable to contract activity in general and can be allocated to the contract; and

(iii) such other costs as are specifically chargeable to the customer under the terms of the contract.

Note:

1. Costs that relate directly to a specific contract include:

(a) site labour costs, including site supervision

(b) costs of materials used in construction

(c) depreciation of plant and equipment used on the contract
(d) costs of moving plant, equipment and materials to and from the contract site
(e) costs of hiring plant and equipment
(f) costs of design and technical assistance that is directly related to the contract
(g) the estimated costs of rectification and guarantee work, including expected warranty costs
(h) claims from third parties

Direct costs can be reduced by incidental income that is not included in contract revenue, e.g. sale of surplus material and disposal of plant and equipment.

2. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

(a) insurance
(b) costs of design and technical assistance that is not directly related to a specific contract
(c) construction overheads

The allocation of indirect costs should be based on normal levels of construction activity. The allocable costs may include borrowing costs as per AS 16.

3. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

(a) general administration costs for which reimbursement is not specified in the contract
(b) selling costs
(c) research and development costs for which reimbursement is not specified in the contract
(d) depreciation of idle plant and equipment that is not used on a particular contract

**Changes in Estimates (Para 37)**

The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate in accordance with
AS 5. The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

**Disclosure**

(a) An enterprise should disclose:

(i) the amount of contract revenue recognised as revenue in the period;
(ii) the methods used to determine the contract revenue recognised in the period; and
(iii) the methods used to determine the stage of completion of contracts in progress.

(b) An enterprise should disclose following in respect of contracts in progress at the reporting date:

(i) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;
(ii) the amount of advances received; and
(iii) the amount of retentions.

(c) An enterprise should present:

(i) the gross amount due from customers for contract work as an asset; and
(ii) the gross amount due to customers for contract work as a liability.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs incurred</td>
<td>xxx</td>
</tr>
<tr>
<td>Plus: Recognised profits</td>
<td>xxx</td>
</tr>
<tr>
<td>Less: Recognised losses</td>
<td>xxx</td>
</tr>
<tr>
<td>Less: Progress billings</td>
<td>xxx</td>
</tr>
</tbody>
</table>
Amount | xxx
---|---
If above amount is **positive** - Gross amount due from customers
If above amount is **negative** - Gross amount due from customers

### Miscellaneous Illustrations

#### Illustration 1

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2017.

<table>
<thead>
<tr>
<th><strong>(₹ in lakhs)</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Contract Price</strong></td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Work Certified</strong></td>
<td>500</td>
</tr>
<tr>
<td><strong>Work not Certified</strong></td>
<td>105</td>
</tr>
<tr>
<td><strong>Estimated further Cost to Completion</strong></td>
<td>495</td>
</tr>
<tr>
<td><strong>Progress Payment Received</strong></td>
<td>400</td>
</tr>
<tr>
<td><strong>To be Received</strong></td>
<td>140</td>
</tr>
</tbody>
</table>

The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS 7 issued by your institute.

### Solution

<table>
<thead>
<tr>
<th><strong>(a)</strong></th>
<th>Amount of foreseeable loss</th>
<th><strong>(₹ in lakhs)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total cost of construction (500 + 105 + 495)</strong></td>
<td>1,100</td>
<td></td>
</tr>
<tr>
<td><strong>Less: Total contract price</strong></td>
<td>(1,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Total foreseeable loss to be recognised as expense</strong></td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

According AS 7, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

<table>
<thead>
<tr>
<th><strong>(b)</strong></th>
<th>Contract work-in-progress i.e. cost incurred to date are ₹ 605 lakhs</th>
<th><strong>(₹ in lakhs)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Work certified</strong></td>
<td>500</td>
<td></td>
</tr>
<tr>
<td><strong>Work not certified</strong></td>
<td>105</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>605</td>
<td></td>
</tr>
</tbody>
</table>
APPLICATION OF ACCOUNTING STANDARDS

This is 55% \((605/1,100 \times 100)\) of total costs of construction.

(c) Proportion of total contract value recognised as revenue:
55% of ₹ 1,000 lakhs = ₹ 550 lakhs

(d) Amount due from/to customers = (Contract costs + Recognised profits – Recognised Losses) – (Progress payments received + Progress payments to be received)
= \((605 + \text{Nil} – 100) – (400 + 140)\) ₹ in lakhs
= \([505 – 540]\) ₹ in lakhs

Amount due to customers = ₹ 35 lakhs

The amount of ₹ 35 lakhs will be shown in the balance sheet as liability.

(e) The relevant disclosures under AS 7 are given below:

<table>
<thead>
<tr>
<th></th>
<th>₹ in lakhs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract revenue</td>
<td>550</td>
</tr>
<tr>
<td>Contract expenses</td>
<td>605</td>
</tr>
<tr>
<td>Recognised profits less recognised losses</td>
<td>(100)</td>
</tr>
<tr>
<td>Progress billings ₹ (400 + 140)</td>
<td>540</td>
</tr>
<tr>
<td>Retentions (billed but not received from contractee)</td>
<td>140</td>
</tr>
<tr>
<td>Gross amount due to customers</td>
<td>35</td>
</tr>
</tbody>
</table>

Illustration 2

On 1st December, 2016, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2017, the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2017 as per provisions of Accounting Standard 7 (Revised)?

Solution

<table>
<thead>
<tr>
<th></th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost incurred till 31st March, 2017</td>
<td>64,99,000</td>
</tr>
<tr>
<td>Prudent estimate of additional cost for completion</td>
<td>32,01,000</td>
</tr>
</tbody>
</table>
Total cost of construction | 97,00,000
---|---
Less: Contract price | (85,00,000)
Total foreseeable loss | 12,00,000

According to AS 7, the amount of ₹ 12,00,000 is required to be recognised as an expense.

Contract work in progress = \( \frac{\text{₹ 64,99,000} \times 100}{97,00,000} \) = 67%

Proportion of total contract value recognised as turnover:

\[ = 67\% \text{ of ₹ 85,00,000} = ₹ 56,95,000. \]

### 2.2 REVENUE RECOGNITION (AS 9)

AS 9 is mandatory for all enterprises.

AS 9 deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

- the sale of goods
- the rendering of services
- the use by others of enterprise resources yielding interest, royalties and dividends

**AS 9 does not deal with the following aspects of revenue recognition to which special considerations apply:**

i. Revenue arising from construction contracts;

ii. Revenue arising from hire-purchase, lease agreements;

iii. Revenue arising from government grants and other similar subsidies;

iv. Revenue of insurance companies arising from insurance contracts.

Examples of items not included within the definition of “revenue” for the purpose of AS 9 are:

i. Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

ii. Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
iii. Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

iv. Realised gains resulting from the discharge of an obligation at less than its carrying amount;

v. Unrealised gains resulting from the restatement of the carrying amount of an obligation.

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

**Sale of Goods**

Revenue from sales or service transactions should be recognised when the requirements as to performance set out in below paragraph are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

**Rendering of Services**

Revenue from service transactions is usually recognised as the service is performed. There are two methods of recognition of revenue from service transaction, viz,
Proportionate Completion Method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract. Here performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act.

Completed Service Contract Method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed. In this method performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

Revenue from sales or service transactions should be recognised when the requirements as to performance set out below paragraph are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.
Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

Use by others of such enterprise resources gives rise to:

i. Interest: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognised on a time proportion basis taking into account the amount outstanding and the rate applicable.

ii. Royalties: charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognised on an accrual basis in accordance with the terms of the relevant agreement.

iii. Dividends: rewards from the holding of investments in shares. Revenue is recognised when the owner’s right to receive payment is established.

Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists.

* Sale of goods “for consideration” should be considered as situation when no significant uncertainty exists regarding amount of consideration.
Effect of Uncertainties on Revenue Recognition

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases:

When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

Disclosure

An enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

Miscellaneous Illustrations

Illustration 1

The Board of Directors decided on 31.3.2017 to increase the sale price of certain items retrospectively from 1st January, 2017. In view of this price revision with effect from 1st January 2017, the company has to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2017 to 31st March, 2017. Accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 2016-2017. Advise.

Solution

Price revision was effected during the current accounting period 2016-2017. As a result, the company stands to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2017 to 31st March, 2017. If the company is able to assess the ultimate collection with reasonable certainty, then additional revenue arising out of the said price revision may be recognised in 2016-2017.

Illustration 2

Y Ltd., used certain resources of X Ltd. In return X Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respective from Y Ltd. during the year 2016-17. You are required to state whether and on what basis these revenues can be recognised by X Ltd.
Solution

As per AS 9 on Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest and royalties should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

(i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.

(ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement.

Illustration 3

A claim lodged with the Railways in March, 2015 for loss of goods of ₹ 2,00,000 had been passed for payment in March, 2017 for ₹ 1,50,000. No entry was passed in the books of the Company, when the claim was lodged. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2017.

Solution

AS 9 on ‘Revenue Recognition’ states that where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised. In this case it may be assumed that collectability of claim was not certain in the earlier periods. This is supposed from the fact that only ₹ 1,50,000 were collected against a claim of ₹ 2,00,000. So this transaction can not be taken as a Prior Period Item.

In the light of AS 5, it will not be treated as extraordinary item. However, AS 5 states that when items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Accordingly, the nature and amount of this item should be disclosed separately.
2.3 ACCOUNTING FOR AMALGAMATIONS (AS 14 (REVISED))

Introduction

AS 14 (Revised) deals with the accounting to be made in the books of Transferee company in the case of amalgamation and the treatment of any resultant goodwill or reserve.

An amalgamation may be either in the nature of merger or purchase. The standard specifies the conditions to be satisfied by an amalgamation to be considered as amalgamation in nature of merger or purchase.

An amalgamation in nature of merger is accounted for as per pooling of interests method and in nature of purchase is dealt under purchase method.

The standard describes the disclosure requirements for both types of amalgamations in the first financial statements. We will discuss the other amalgamation aspects in detail in subsequent paragraphs of this unit.

AS 14 (Revised) does not deal with cases of acquisitions. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

Definition of the Terms used in the Standard

➢ **Amalgamation** means an amalgamation pursuant to the provisions of the Companies Act, 2013 or any other statute which may be applicable to companies and includes ‘merger’.

➢ **Transferor company** means the company which is amalgamated into another company.

➢ **Transferee company** means the company into which a transferor company is amalgamated.

Types of Amalgamations

Amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders’ interests and of the businesses of these companies. These are known as Amalgamation in nature of merger. In the second category are those amalgamations which are in effect a mode by which one company acquires another company and, as a consequence, the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company.
or the business of the company which is acquired is not intended to be continued. Such amalgamations are amalgamations in the nature of 'purchase'.

**Amalgamation in the Nature of Merger**

Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions.

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

**Amalgamation in the Nature of Purchase**

Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified above.
Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamations.

➢ the pooling of interests method and
➢ the purchase method.

Pooling of Interests Method

Pooling of interests is a method of accounting for amalgamations the object of which is to account for the amalgamation as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies.

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (after making adjustment required in next paragraph).

If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5.

Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either

➢ By incorporating the assets and liabilities at their existing carrying amounts or
➢ By allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

Consideration

Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. In determining the value of the consideration, an assessment is made of the fair value of its elements.

Many amalgamations recognise that adjustments may have to be made to the
APPLICATION OF ACCOUNTING STANDARDS

consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [AS 4].

Treatment of Reserves of the Transferor Company on Amalgamation

If the amalgamation is an ‘amalgamation in the nature of merger’, the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. Thus, for example, the General Reserve of the transferor company becomes the General Reserve of the transferee company, the Capital Reserve of the transferor company becomes the Capital Reserve of the transferee company and the Revaluation Reserve of the transferor company becomes the Revaluation Reserve of the transferee company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation.

Adjustments to reserves - Amalgamation in the Nature of Merger

When an amalgamation is accounted for using the pooling of interests method, the reserves of the transferee company are adjusted to give effect to the following:

- Conflicting accounting policies of the transferor and the transferee. A uniform set of accounting policies should be adopted following the amalgamation and, hence, the policies of the transferor and the transferee are aligned. The effects on the financial statements of this change in the accounting policies is reported in accordance with AS 5 ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies’
- Difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company.

Adjustments to reserves - Amalgamation in the Nature of Purchase

If the amalgamation is an ‘amalgamation in the nature of purchase’, the identity of the reserves, other than the statutory reserves is not preserved. The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the
result of the computation is positive, the difference is credited to Capital Reserve. Certain reserves may have been created by the transferor company pursuant to the requirements of, or to avail of the benefits under, the Income-tax Act, 1961; for example, Development Allowance Reserve, or Investment Allowance Reserve. The Act requires that the identity of the reserves should be preserved for a specified period. Likewise, certain other reserves may have been created in the financial statements of the transferor company in terms of the requirements of other statutes. Though normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as ‘statutory reserves’) and such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., ‘Amalgamation Adjustment Reserve’) which is presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

The Standard gives a title, which reads as "Reserve". This gives rise to following requirements.

1. The corresponding debit is "also" to a Reserve Account
2. That Reserve account will show a negative balance
3. But it has to be shown as a separate line item - Which implies, that this debit "cannot be set off against Statutory reserve taken over".

So the presentation will be as follows:

Notes to Accounts for “Reserves and Surplus”

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (Current year)</th>
<th>Amount (Previous Year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory Reserve (taken over from transferor company)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General Reserve</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Treatment of Goodwill Arising on Amalgamation

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

Factors which may be considered in estimating the useful life of goodwill arising on amalgamation include:

(a) the foreseeable life of the business or industry
(b) the effects of product obsolescence, changes in demand and other economic factors
(c) the service life expectancies of key individuals or groups of employees
(d) expected actions by competitors or potential competitors
(e) legal, regulatory or contractual provisions affecting the useful life

Balance of Profit and Loss Account

In the case of an ‘amalgamation in the nature of merger’, the balance of the Profit and Loss Account appearing in the financial statements of the transferor company is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve, if any.

In the case of an ‘amalgamation in the nature of purchase’, the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

Disclosures

For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Names and general nature of business of the amalgamating companies;
b. Effective date of amalgamation for accounting purposes;
c. The method of accounting used to reflect the amalgamation; and
d. Particulars of the scheme sanctioned under a statute.

For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Description and number of shares issued, together with the percentage of each company’s equity shares exchanged to effect the amalgamation;
b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Consideration for the amalgamation and a description of the consideration paid or contingently payable; and
b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

**Amalgamation after the Balance Sheet Date**

When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation is not incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

**Miscellaneous Illustrations**

**Illustration 1**

A Ltd. take over B Ltd. on April 01, 2017 and discharges consideration for the business as follows:

(i) Issued 42,000 fully paid equity shares of ₹ 10 each at par to the equity shareholders of B Ltd.
(ii) Issued fully paid up 15% preference shares of ₹ 100 each to discharge the preference shareholders (₹ 1,70,000) of B Ltd. at a premium of 10%.

(iii) It is agreed that the debentures of B Ltd. (₹ 50,000) will be converted into equal number and amount of 13% debentures of A Ltd.

Determine the amount of purchase consideration as per AS 14.

Solution

<table>
<thead>
<tr>
<th>Particulars</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Shares (42,000 x 10)</td>
<td>4,20,000</td>
</tr>
<tr>
<td>15% Preference Share Capital</td>
<td>1,70,000</td>
</tr>
<tr>
<td>Add: Premium on Redemption</td>
<td>17,000</td>
</tr>
<tr>
<td>Purchase Consideration</td>
<td>6,07,000</td>
</tr>
</tbody>
</table>

Note: As per AS 14, consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. Thus, payment to debenture holders are not covered by the term ‘consideration’.

Illustration 2

A Ltd. and B Ltd. were amalgamated on and from 1st April, 2017. A new company C Ltd. was formed to take over the business of the existing companies. The summarised Balance Sheets of A Ltd. and B Ltd. as on 31st March, 2017 are given below:

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>(₹ in lakhs)</th>
<th>Assets</th>
<th>(₹ in lakhs)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A Ltd.</td>
<td>B Ltd.</td>
<td>A Ltd.</td>
</tr>
<tr>
<td>Share Capital</td>
<td></td>
<td></td>
<td>Fixed Assets</td>
</tr>
<tr>
<td>Equity Shares of ₹ 100 each</td>
<td>800</td>
<td>750</td>
<td>Land and Building</td>
</tr>
<tr>
<td>12% Preference shares of ₹ 100 each</td>
<td>300</td>
<td>200</td>
<td>Plant and Machinery</td>
</tr>
<tr>
<td>Reserves and Surplus</td>
<td></td>
<td></td>
<td>Investments</td>
</tr>
<tr>
<td>Revaluation Reserve</td>
<td>150</td>
<td>100</td>
<td>Current Assets, Loans and Advances</td>
</tr>
<tr>
<td>General Reserve</td>
<td>170</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Investment Allowance Reserve</td>
<td>50</td>
<td>50</td>
<td>Inventory</td>
</tr>
</tbody>
</table>
Additional Information:

(1) 10% Debenture holders of A Ltd. and B Ltd. are discharged by C Ltd. issuing such number of its 15% Debentures of ₹ 100 each so as to maintain the same amount of interest.

(2) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of C Ltd. at a price of ₹ 150 per share (face value of ₹ 100).

(3) C Ltd. will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares for each equity share of B Ltd. The shares are to be issued @ ₹ 30 each, having a face value of ₹ 10 per share.

(4) Investment allowance reserve is to be maintained for 4 more years.

Prepare the Balance Sheet of C Ltd. as on 1st April, 2017 after the amalgamation has been carried out on the basis of Amalgamation in the nature of purchase.

Solution

Balance Sheet of C Ltd. as at 1st April, 2017

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Note No.</th>
<th>(₹ in lakhs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Equity and Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) Shareholder’s Funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Share Capital</td>
<td>1</td>
<td>1,200</td>
</tr>
<tr>
<td>(b) Reserves and Surplus</td>
<td>2</td>
<td>1,650</td>
</tr>
<tr>
<td>(2) Non-Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term borrowings</td>
<td>3</td>
<td>60</td>
</tr>
<tr>
<td>(3) Current Liabilities</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
APPLICATION OF ACCOUNTING STANDARDS

<table>
<thead>
<tr>
<th></th>
<th>Trade payables</th>
<th>8</th>
<th>610</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>3,520</td>
</tr>
</tbody>
</table>

II. Assets

(1) Non-current assets
   (a) Fixed assets
      i. Tangible assets | 4 | 1,550 |
      ii. Intangible assets | 5 | 20 |
   (b) Non-current investments | 6 | 200 |

(2) Current assets
   (a) Inventory (350 + 250) | | 600 |
   (b) Trade receivables | 7 | 650 |
   (c) Cash and bank balances (300 + 200) | | 500 |

Total | | 3,520 |

Notes to Accounts

<table>
<thead>
<tr>
<th></th>
<th>(₹ in lakhs)</th>
<th>(₹ in lakhs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Share Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Equity share capital (W.N.2)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>70,00,000 Equity shares of ₹ 10 each</td>
<td>700</td>
</tr>
<tr>
<td></td>
<td>5,00,000 Preference shares of ₹ 100 each</td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>(all the above shares are allotted as fully paid-up pursuant to contracts without payment being received in cash)</td>
<td>1,200</td>
</tr>
<tr>
<td>2. Reserves and surplus</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Securities Premium Account (W.N.3) (950 + 700)</td>
<td>1,650</td>
</tr>
<tr>
<td></td>
<td>Investment Allowance Reserve (50 + 50)</td>
<td>100</td>
</tr>
</tbody>
</table>

---

1 40,00,000 + 30,00,000
2 3,00,000 + 2,00,000

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### Working Notes:

<table>
<thead>
<tr>
<th>(\textdollar\text{in lakhs})</th>
<th>A Ltd.</th>
<th>B Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Computation of Purchase consideration</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Preference shareholders:</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| \[
\left( \frac{3,00,00,000}{100} \right) \text{ i.e. 3,00,000 shares} \times \text{\textdollar}\text{150 each} & 450 \\
\left( \frac{2,00,00,000}{100} \right) \text{ i.e. 2,00,000 shares} \times \text{\textdollar}\text{150 each} & 300 \\
\] | | |
| (b) Equity shareholders: | | |
| \[
\left( \frac{8,00,00,000 \times 5}{100} \right) \text{ i.e. 40,00,000 shares} \times \text{\textdollar}\text{30 each} & 1,200 \\
\left( \frac{7,50,00,000 \times 4}{100} \right) \text{ i.e. 30,00,000 shares} \times \text{\textdollar}\text{30 each} & 900 \\
\] | | |
| Amount of Purchase Consideration | 1,650 | 1,200 |
| (2) Net Assets Taken Over | | |
| Assets taken over: | | |
| Land and Building | 550 | 400 |
APPLICATION OF ACCOUNTING STANDARDS

<table>
<thead>
<tr>
<th></th>
<th>A Ltd.</th>
<th>B Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant and Machinery</td>
<td>350</td>
<td>250</td>
</tr>
<tr>
<td>Investments</td>
<td>150</td>
<td>50</td>
</tr>
<tr>
<td>Inventory</td>
<td>350</td>
<td>250</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>300</td>
<td>350</td>
</tr>
<tr>
<td>Cash and bank</td>
<td>300</td>
<td>200</td>
</tr>
<tr>
<td><strong>Less: Liabilities taken over:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debentures</td>
<td>40</td>
<td>20</td>
</tr>
<tr>
<td>Trade payables</td>
<td>420</td>
<td>190</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>460</td>
<td>210</td>
</tr>
<tr>
<td>Net assets taken over</td>
<td>1,540</td>
<td>1,290</td>
</tr>
<tr>
<td>Purchase consideration</td>
<td>1,650</td>
<td>1,200</td>
</tr>
<tr>
<td>Goodwill</td>
<td>110</td>
<td></td>
</tr>
<tr>
<td>Capital reserve</td>
<td></td>
<td>90</td>
</tr>
<tr>
<td>(3) Computation of securities premium</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On preference share capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A Ltd.- 3,00,000 x 50</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>B Ltd.- 2,00,000 x 50</td>
<td></td>
<td>100</td>
</tr>
<tr>
<td>On equity share capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A Ltd.- 40,00,000 x 20</td>
<td>800</td>
<td></td>
</tr>
<tr>
<td>B Ltd.- 30,00,000 x 20</td>
<td></td>
<td>600</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>950</td>
<td>700</td>
</tr>
</tbody>
</table>

Note: For problems based on practical application of AS 14 (Revised), students are advised to refer Chapter 6 ‘Accounting for Amalgamation of Companies’ of the study material.

2.4 AS 18: RELATED PARTY DISCLOSURES

Introduction

AS 18 prescribes the requirements for disclosure of related party relationship and transactions between the reporting enterprise and its related parties. The requirements of the standard apply to the financial statements of each reporting
Related Party Relationships

Related party - parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

AS 18 deals only with related party relationships described in (a) to (e) below:

a. Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries).

b. Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.

c. Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual.

d. Key management personnel and relatives of such personnel and

e. Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

In the context of AS 18, the following are deemed not to be related parties:

a. Two companies simply because they have a director in common (unless the director is able to affect the policies of both companies in their mutual dealings).

b. A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence and

c. The parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):
APPLICATION OF ACCOUNTING STANDARDS

(i) Providers of finance
(ii) Trade unions
(iii) Public utilities
(iv) Government departments and government agencies including government sponsored bodies

Related party disclosure requirements as laid down in AS 18 do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise’s duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

No disclosure is required in consolidated financial statements in respect of intra-group transactions.

No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

Definitions of other Terms used in AS 18

Related party transaction: A transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Control: (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or
(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or
(c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

For the purpose of AS 18, an enterprise is considered to control the composition of the board of directors of a company or governing body of an enterprise, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors/members of the governing body of that company/enterprise. An enterprise is deemed to have the power to appoint a director/member of the governing body, if any of the following conditions is satisfied:

(a) A person cannot be appointed as director/member of the governing body without the exercise in his favour by that enterprise of such a power as aforesaid or
(b) A person’s appointment as director/member of the governing body follows necessarily from his appointment to a position held by him in that enterprise or

(c) The director/member of the governing body is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

An enterprise/individual is considered to have a **substantial interest** in another enterprise if that enterprise or individual owns, directly or indirectly, 20% or more interest in the voting power of the other enterprise. Similarly, an individual is considered to have a substantial interest in an enterprise, if that individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the enterprise.

**An Associate:** An enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

**Significant influence:** Participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies.

It may be exercised in several ways, for example, by representation on the board of directors, participation in the policy making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information.

Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investing party holds, directly or indirectly through intermediaries, 20 per cent or more of the voting power of the enterprise, it is presumed that the investing party does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investing party holds, directly or indirectly through intermediaries, less than 20% of the voting power of the enterprise, it is presumed that the investing party does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investing party does not necessarily preclude an investing party from having significant influence.
Illustration 1

Identify the related parties in the following cases as per AS 18

A Ltd. holds 51% of B Ltd.
B Ltd holds 51% of O Ltd.
Z Ltd holds 49% of O Ltd.

Solution

Reporting entity- A Ltd.
- B Ltd. (subsidiary) is a related party
- O Ltd. (subsidiary) is a related party

Reporting entity- B Ltd.
- A Ltd. (holding company) is a related party
- O Ltd. (subsidiary) is a related party

Reporting entity- O Ltd.
- A Ltd. (holding company) is a related party
- B Ltd. (holding company) is a related party
- Z Ltd. (investor/ investing party) is a related party

Reporting entity- Z Ltd.
- O Ltd. (associate) is a related party

Key Management Personnel: Those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

For example, in the case of a company, the managing directors, whole time directors, manager and any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel.

A non-executive director of a company should not be considered as a key management person by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

The requirements of AS 18 should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of
the enterprise, unless he falls in any of the categories of ‘related party relationships’ discussed above.

**Relative:** In relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

**Joint Venture** - a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

**Joint Control** – the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

**Holding Company** – a company having one or more subsidiaries.

**Subsidiary** - a company:

(a) in which another company (the holding company) holds, either by itself and/or through one or more subsidiaries, more than one-half, in nominal value of its equity share capital; or

(b) of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.

**Fellow subsidiary** – a company is considered to be a fellow subsidiary of another company if both are subsidiaries of the same holding company.

**The Related Party Issue**

Related party relationships are a normal feature of commerce and business. For example, enterprises frequently carry on separate parts of their activities through subsidiaries or associates and acquire interests in other enterprises - for investment purposes or for trading reasons - that are of sufficient proportions for the investing enterprise to be able to control or exercise significant influence on the financial and/or operating decisions of its investee.

Without related party disclosures, there is a general presumption that transactions reflected in financial statements are consummated on an arm’s-length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into. Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties. Sometimes, no price is charged in related party transactions, for example, free provision of management services and the extension of free credit on a debt. In view of the aforesaid, the resulting
accounting measures may not represent what they usually would be expected to represent. Thus, a related party relationship could have an effect on the financial position and operating results of the reporting enterprise.

The operating results and financial position of an enterprise may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the reporting enterprise with other parties. For example, a subsidiary may terminate relations with a trading partner on acquisition by the holding company of a fellow subsidiary engaged in the same trade as the former partner. Alternatively, one party may refrain from acting because of the control or significant influence of another - for example, a subsidiary may be instructed by its holding company not to engage in research and development.

Sometimes, transactions would not have taken place if the related party relationship had not existed. For example, a company that sold a large proportion of its production to its holding company at cost might not have found an alternative customer if the holding company had not purchased the goods.

In view of the aforesaid, the resulting accounting measures may not represent what they usually would be expected to represent. Thus, a related party relationship could have an effect on the financial position and operating results of the reporting enterprise.

As per the Guidance Note on ‘Remuneration paid to Key Management Personnel - Whether a Related Party Transaction’, remuneration paid to key management personnel should be considered as a related party transaction requiring disclosures. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

**Disclosure**

Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

This is to enable users of financial statements to form a view about the effects of related party relationships on the enterprise.

If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

(i) The name of the transacting related party;
(ii) A description of the relationship between the parties;
(iii) A description of the nature of transactions;
(iv) Volume of the transactions either as an amount or as an appropriate proportion;
(v) Any other elements of the related party transactions necessary for an understanding of the financial statements;
(vi) The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;
(vii) Amounts written off or written back in the period in respect of debts due from or to related parties.

Items of a similar nature may be disclosed in aggregate by type of related party except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.

**Illustration**

*Narmada Ltd. sold goods for ₹ 90 lakhs to Ganga Ltd. during financial year ended 31-3-2017. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct?*

**Solution**

As per AS 18 ‘Related Party Disclosures’, Enterprises over which a key management personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprise that have a member of key management in common with the reporting enterprise.

In the given case, Narmada Ltd. and Ganga Ltd are related parties and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price.

Hence the contention of Chief Accountant of Narmada Ltd is wrong.
2.5 AS 19: LEASES

Introduction
The objective of AS 19 is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

A Lease is an agreement whereby the Lessor (legal owner of an asset) conveys to the Lessee (another party) in return for a payment or series of periodic payments (Lease rents), the right to use an asset for an agreed period of time.

Applicability of AS 19
The standard applies to all leases other than:

(a) lease agreements to explore for or use of natural resources, such as oil, gas, timber metals and other mineral rights; and

(b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and

(c) lease agreements to use lands

(d) agreements that are contracts for services, that do not transfer right to use assets from one contracting party to the other.

Definitions
A non-cancellable lease is a lease that is cancellable only:

(a) upon the occurrence of some remote contingency; or

(b) with the permission of the lessor; or

(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.
Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

(a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or

(b) in the case of the lessor, any residual value guaranteed to the lessor:

(i) by or on behalf of the lessee; or

(ii) by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm’s length transaction.

Economic life is either:

(a) the period over which an asset is expected to be economically usable by one or more users; or

(b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life of a leased asset is either:

(a) the period over which the leased asset is expected to be used by the lessee; or

(b) the number of production or similar units expected to be obtained from the use of the asset by the lessee.

Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.

Guaranteed residual value is:

(a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

(b) in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.
Unguaranteed residual value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

Unearned finance income is the difference between:
(a) the gross investment in the lease; and
(b) the present value of
(i) the minimum lease payments under a finance lease from the standpoint of the lessor; and
(ii) any unguaranteed residual value accruing to the lessor,
at the interest rate implicit in the lease.

Net investment in the lease is the gross investment in the lease less unearned finance income.

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of
(a) the minimum lease payments under a finance lease from the standpoint of the lessor; and
(b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

The lessee’s incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

Types of leases
For accounting purposes, leases are classified as:
(i) Finance leases; and
(ii) Operating leases.

A Finance Lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not be eventually transferred.
A lease is classified as an *Operating Lease* if it does not transfer substantially all the risk and rewards incident to ownership.

**Indicators of Finance Lease**

Situations, which would normally lead to a lease being classified as a finance lease are:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

(c) The lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) At the inception of the lease, present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) The leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

(a) If the lessee can cancel the lease and the lessor’s losses associated with the cancellation are borne by the lessee;

(b) If gains or losses from the fluctuations in the residual value accrue to the lessee (for example if the lessor agrees to allow rent rebate equaling most of the disposal value of leased asset at the end of the lease); and

(c) If the lessee can continue the lease for a secondary period at a rent, which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.
Accounting for Finance Leases (Books of lessee)

Following is the accounting treatment of Finance Leases in the books of Lessee:

(i) On the date of inception of Lease, Lessee should show it as an asset and corresponding liability at lower of:
   - Fair value of leased asset at the inception of the lease
   - Present value of minimum lease payments from the standpoint of the lessee (present value to be calculated with discount rate equal to interest rate implicit in the lease, if this is practicable to determine; if not, the lessee’s incremental borrowing rate should be used)

(ii) Lease payments to be apportioned between the finance charge and the reduction of the outstanding liability.

(iii) Finance charges to be allocated to periods during the lease term so as to produce a constant rate of interest on the remaining balance of liability for each period.

(iv) A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in AS 10 (Revised), Property, Plant and Equipment. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

(v) Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

Computation of interest rate implicit on lease

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of:

(a) the minimum lease payments under a finance lease from the standpoint of the lessor; and

(b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.
Discounting rate = R% p.a;
Lease Rents = L₁, L₂ ......... Lₙ (Payable annually, at the end of each year)
Lease period = n years;
Guaranteed residual value = GR;
Unguaranteed residual value = UGR

Fair Value at the inception (beginning) of lease = FV

\[ PV \text{ of MLP} = \frac{L₁}{(1+R)^1} + \frac{L₂}{(1+R)^2} + \frac{Lₙ}{(1+R)^n} + \frac{GR}{(1+R)^n} \]

Present value of unguaranteed residual value = \( \frac{UGR}{(1+R)^n} \)

If interest rate implicit on lease is used as discounting rate:

Fair Value = PV of Minimum Lease Payments + PV of unguaranteed residual value ..... (1)

The interest rate implicit on lease can be computed by trial and error, provided the information required, e.g. the unguaranteed residual value can be reasonably ascertained.

**Example 1**

*Annual lease rents = ₹50,000 at the end of each year.*

*Lease period = 5 years;*

*Guaranteed residual value = ₹25,000*

*Unguaranteed residual value (UGR) = ₹15,000*

*Fair Value at the inception (beginning) of lease = ₹2,00,000*

*Interest rate implicit on lease is computed below:*

*Interest rate implicit on lease is a discounting rate at which present value of minimum lease payments and unguaranteed residual value is ₹2 lakhs.*

\[
\begin{array}{|c|c|c|c|}
\hline
\text{Year} & MLP + UGR \text{ ₹} & DF (10\%) & PV \text{ ₹} \\
\hline
1 & 50,000 & 0.909 & 45,450 \\
2 & 50,000 & 0.826 & 41,300 \\
\hline
\end{array}
\]
APPLICATION OF ACCOUNTING STANDARDS

<table>
<thead>
<tr>
<th>Year</th>
<th>MLP + UGR ₹</th>
<th>DF (14%)</th>
<th>PV ₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000</td>
<td>0.877</td>
<td>43,850</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>0.769</td>
<td>38,450</td>
</tr>
<tr>
<td>3</td>
<td>50,000</td>
<td>0.675</td>
<td>33,750</td>
</tr>
<tr>
<td>4</td>
<td>50,000</td>
<td>0.592</td>
<td>29,600</td>
</tr>
<tr>
<td>5</td>
<td>50,000</td>
<td>0.519</td>
<td>25,950</td>
</tr>
<tr>
<td>5</td>
<td>25,000</td>
<td>0.519</td>
<td>12,975</td>
</tr>
<tr>
<td>5</td>
<td>15,000</td>
<td>0.519</td>
<td>7,785</td>
</tr>
</tbody>
</table>

PV of minimum lease payments and unguaranteed residual value at guessed rate 14%

Interest rate implicit on lease is computed below by interpolation:

\[
\text{Interest rate implicit on lease} = 10\% + \frac{14\% - 10\%}{2,14,340 - 1,92,360} \times (2,14,340 - 2,00,000) = 12.6\%
\]

Example 2

Present value of minimum lease payment using data for example 1 is computed below:

<table>
<thead>
<tr>
<th>Year</th>
<th>MLP ₹</th>
<th>DF (12.6%)</th>
<th>PV ₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000</td>
<td>0.890</td>
<td>44,500</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>0.790</td>
<td>39,500</td>
</tr>
<tr>
<td>3</td>
<td>50,000</td>
<td>0.700</td>
<td>35,000</td>
</tr>
<tr>
<td>4</td>
<td>50,000</td>
<td>0.622</td>
<td>31,100</td>
</tr>
<tr>
<td>5</td>
<td>50,000</td>
<td>0.552</td>
<td>27,600</td>
</tr>
</tbody>
</table>
Present value of minimum lease payment = ₹ 1,91,500

Fair value of leased asset = ₹ 2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

<table>
<thead>
<tr>
<th>Asset A/c</th>
<th>Dr.</th>
<th>To Lessor A/c</th>
<th>1,91,500</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>(Being recognition of finance lease as asset and liability)</td>
<td>1,91,500</td>
</tr>
</tbody>
</table>

**Example 3**

Using data for example 1 and assuming zero residual value, allocation of finance charge over lease period is shown below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Minimum Lease Payments</th>
<th>Finance Charge (12.6%)</th>
<th>Principal</th>
<th>Principal due</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>1,91,500</td>
</tr>
<tr>
<td>1</td>
<td>50,000</td>
<td>24,129</td>
<td>25,871</td>
<td>1,65,629</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>20,869</td>
<td>29,131</td>
<td>1,36,498</td>
</tr>
<tr>
<td>3</td>
<td>50,000</td>
<td>17,199</td>
<td>32,801</td>
<td>1,03,697</td>
</tr>
<tr>
<td>4</td>
<td>50,000</td>
<td>13,066</td>
<td>36,934</td>
<td>66,763</td>
</tr>
<tr>
<td>5</td>
<td>75,000</td>
<td>8,237*</td>
<td>66,763</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2,75,000</td>
<td>83,500</td>
<td>1,91,500</td>
<td></td>
</tr>
</tbody>
</table>

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

<table>
<thead>
<tr>
<th>Finance Charge A/c</th>
<th>Dr.</th>
<th>24,129</th>
</tr>
</thead>
</table>

* The difference between this figure and finance charge [66,763×12.6%=8412] is due to approximation in computation.
APPLICATION OF ACCOUNTING STANDARDS

<table>
<thead>
<tr>
<th>To Lessor</th>
<th>24,129</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Being finance charge due for the year)</td>
<td></td>
</tr>
<tr>
<td>Lessor</td>
<td>50,000</td>
</tr>
<tr>
<td>Dr.</td>
<td></td>
</tr>
<tr>
<td>To Bank A/c</td>
<td>50,000</td>
</tr>
<tr>
<td>(Being payment of lease rent for the year)</td>
<td></td>
</tr>
<tr>
<td>P &amp; L A/c</td>
<td>24,129</td>
</tr>
<tr>
<td>Dr.</td>
<td></td>
</tr>
<tr>
<td>To Finance Charge A/c</td>
<td>24,129</td>
</tr>
<tr>
<td>(Being recognition of finance charge as expense for the year)</td>
<td></td>
</tr>
</tbody>
</table>

**Example 4**

In example 1, suppose unguaranteed residual value is not determinable and lessee’s incremental borrowing rate is 10%.

Since interest rate implicit on lease is discounting rate at which present value of minimum lease payment and present value of unguaranteed residual value equals the fair value, interest rate implicit on lease cannot be determined unless unguaranteed residual value is known. If interest rate implicit on lease is not determinable, the present value of minimum lease payments should be determined using lessee’s incremental borrowing rate.

Present value of minimum lease payment using lessee’s incremental borrowing rate 10% is computed below:

<table>
<thead>
<tr>
<th>Year</th>
<th>MLP</th>
<th>DF (10%)</th>
<th>PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000</td>
<td>0.909</td>
<td>45,450</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>0.826</td>
<td>41,300</td>
</tr>
<tr>
<td>3</td>
<td>50,000</td>
<td>0.751</td>
<td>37,550</td>
</tr>
<tr>
<td>4</td>
<td>50,000</td>
<td>0.683</td>
<td>34,150</td>
</tr>
<tr>
<td>5</td>
<td>50,000</td>
<td>0.621</td>
<td>31,050</td>
</tr>
<tr>
<td>5</td>
<td>25,000</td>
<td>0.621</td>
<td>15,525</td>
</tr>
</tbody>
</table>

**Present value of minimum lease payment = ₹ 2,05,025**

**Fair value of leased asset = ₹ 2,00,000**
The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

<table>
<thead>
<tr>
<th>Asset A/c</th>
<th>Dr.</th>
<th>₹</th>
<th>To Lessor</th>
<th>₹</th>
<th>(Being recognition of finance lease as asset and liability)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,00,000</td>
<td>2,00,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Since the liability is recognised at fair value ₹ 2 lakh (total principal), we need to ascertain a discounting rate at which present value minimum lease payments equals ₹ 2 lakh. The discounting rate can then be used for allocation of finance charge over lease period.

**PV of minimum lease payments at guessed rate 12%**

<table>
<thead>
<tr>
<th>Year</th>
<th>Minimum Payments</th>
<th>Lease (₹)</th>
<th>DF (12%)</th>
<th>PV (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50,000</td>
<td>0.893</td>
<td>44,650</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>0.797</td>
<td>39,850</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>50,000</td>
<td>0.712</td>
<td>35,600</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>50,000</td>
<td>0.636</td>
<td>31,800</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>50,000</td>
<td>0.567</td>
<td>28,350</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>25,000</td>
<td>0.567</td>
<td>14,175</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>1,94,425</td>
<td></td>
</tr>
</tbody>
</table>

Required discounting rate = \( 10\% + \frac{12\% - 10\%}{2,05,025 - 1,94,425} \times (2,05,025 - 2,00,000) = 10.95\% \)

**Allocation of finance charge over lease period is shown below:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Minimum Lease Payments (₹)</th>
<th>Finance Charge (10.95%) (₹)</th>
<th>Principal (₹)</th>
<th>Principal due (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>2,00,000</td>
</tr>
<tr>
<td>1</td>
<td>50,000</td>
<td>21,900</td>
<td>28,100</td>
<td>1,71,900</td>
</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>18,823</td>
<td>31,177</td>
<td>1,40,723</td>
</tr>
</tbody>
</table>
Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

<table>
<thead>
<tr>
<th>Description</th>
<th>₹</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance Charge A/c Dr. To Lessor (Being finance charge due for the year)</td>
<td>21,900</td>
<td>21,900</td>
</tr>
<tr>
<td>Lessor Dr. To Bank A/c (Being payment of lease rent for the year)</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>P &amp; L A/c Dr. To Finance Charge (Being recognition of finance charge as expense for the year)</td>
<td>21,900</td>
<td>21,900</td>
</tr>
</tbody>
</table>

Illustration 1

S. Square Private Limited has taken machinery on finance lease from S.K. Ltd. The information is as under:

Lease term = 4 years

Fair value at inception of lease = ₹ 20,00,000

Lease rent = ₹ 6,25,000 p.a. at the end of year

Guaranteed residual value = ₹ 1,25,000

Expected residual value = ₹ 3,75,000

Implicit interest rate = 15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively.

Calculate the value of the lease liability as per AS-19.

* The difference between this figure & finance charge [67,753×10.95% = 7418] is due to approximation in computation
Solution

According to para 11 of AS 19 “Leases”, the lessee should recognise the lease as an asset and a liability at an amount equal to the lower of the fair value of the leased asset at the inception of the finance lease and the present value of the minimum lease payments from the standpoint of the lessee.

In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Minimum Payment ₹</th>
<th>Lease Payment ₹</th>
<th>Internal rate of return (Discount rate @5%)</th>
<th>Present value ₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>6,25,000</td>
<td>0.8696</td>
<td>5,43,500</td>
</tr>
<tr>
<td>2</td>
<td></td>
<td>6,25,000</td>
<td>0.7561</td>
<td>4,72,563</td>
</tr>
<tr>
<td>3</td>
<td></td>
<td>6,25,000</td>
<td>0.6575</td>
<td>4,10,937</td>
</tr>
<tr>
<td>4</td>
<td>7,50,000*</td>
<td></td>
<td>0.5718</td>
<td>4,28,850</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>26,25,000</td>
<td></td>
<td>18,55,850</td>
</tr>
</tbody>
</table>

Present value of minimum lease payments ₹18,55,850 is less than fair value at the inception of lease i.e. ₹ 20,00,000, therefore, the lease liability should be recognised at ₹18,55,850 as per AS 19.

Disclosures made by the Lessee

The lessee should, in addition to the requirements of AS 10 (Revised), Property, Plant and Equipment, and the governing statute, make the following disclosures for finance leases:

(a) assets acquired under finance lease as segregated from the assets owned;
(b) for each class of assets, the net carrying amount at the balance sheet date;
(c) a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:

* Minimum Lease Payment of 4th year includes guaranteed residual value amounting ₹ 1,25,000.
APPLICATION OF ACCOUNTING STANDARDS

1.51

(i) not later than one year;
(ii) later than one year and not later than five years;
(iii) later than five years;

(d) contingent rents recognised as expense in the statement of profit and loss for the period;

(e) the total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date; and

(f) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
   (i) the basis on which contingent rent payments are determined;
   (ii) the existence and terms of renewal or purchase options and escalation clauses; and
   (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Note: The Level II and Level III enterprises (and SMCs) need not make disclosures required by (c), (e) and (f) above.

Accounting for finance leases (Books of lessor)
The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

In a finance lease, the lessor recognises the net investment in lease (which is usually equal to fair value, i.e. usual market price of the asset, as shown below) as receivable by debiting the Lessee A/c.

Gross investment in Lease (GIL)

\[
= \text{Minimum Lease Payments (MLP)} + \text{Unguaranteed Residual value (UGR)}
\]

Net investment in Lease (NIL)

\[
= \text{Gross investment in Lease (GIL)} - \text{Unearned Finance Income (UFI)}.
\]

Unearned finance income (UFI) = GIL – (PV of MLP + PV of UGR)

The discounting rate for the above purpose is the rate of interest implicit in the lease.

From the definition of interest rate implicit on lease:

\[
(PV \text{ of MLP } + PV \text{ of UGR}) = \text{Fair Value}.
\]

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The above definitions imply that:

(a) Unearned Finance Income (UFI) = GIL – Fair Value

(b) Net Investment in Lease = GIL – UFI = GIL – (GIL – Fair Value) = Fair Value

Since the sale and receivables are recognised at net investment in lease, which is equal to fair value: Profit recognised at the inception of lease = Fair Value – Cost

Total earning of lessor = GIL – Cost

= (GIL – Fair Value) + (Fair Value – Cost)

= Unearned Finance Income + (Fair Value – Cost)

The above analysis does not hold where the discounting rate is not equal to interest rate implicit on lease. Such is the case, where the interest rate implicit on lease is artificially low. The discounting rate in such situations should be the commercial rate of interest (refer discussion on ‘manufacturer or dealer lessor’ below).

**Recognition of Finance Income**

The unearned finance income is recognised over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment in lease outstanding.

The constant periodic return is the rate used for discounting, i.e. either the interest rate implicit on lease or the commercial rate of interest.

**Initial Direct Costs**

Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

**Review of unguaranteed residual value by lessor**

AS 19 requires a lessor to review unguaranteed residual value used in computing the gross investment in lease regularly. In case any reduction in the estimated unguaranteed residual value is identified, the income allocation over the remaining lease term is to be revised. Also, any reduction in respect of income already accrued is to be recognised immediately. An upward adjustment of the estimated residual value is not made.
Illustration 2

Prakash Limited leased a machine to Badal Limited on the following terms:

<table>
<thead>
<tr>
<th></th>
<th><em>(₹ in lakhs)</em></th>
</tr>
</thead>
<tbody>
<tr>
<td>(i)</td>
<td>Fair value of the machine</td>
</tr>
<tr>
<td>(ii)</td>
<td>Lease term</td>
</tr>
<tr>
<td>(iii)</td>
<td>Lease rental per annum</td>
</tr>
<tr>
<td>(iv)</td>
<td>Guaranteed residual value</td>
</tr>
<tr>
<td>(v)</td>
<td>Expected residual value</td>
</tr>
<tr>
<td>(vi)</td>
<td>Internal rate of return</td>
</tr>
</tbody>
</table>

Discounted rates for 1st year to 5th year are 0.8696, 0.7561, 0.6575, 0.5718, and 0.4972 respectively.

Ascertain Unearned Finance Income.

Solution

As per AS 19 on Leases, **unearned finance income** is the difference between (a) the **gross investment** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessee, at the interest rate implicit in the lease.

Where:

(a) **Gross investment** in the lease is the aggregate of (i) minimum lease payments from the standpoint of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

**Gross investment** = Minimum lease payments + Unguaranteed residual value

= [(₹ 8,00,000 × 5 years) + ₹ 1,60,000] + ₹ 1,40,000 = ₹ 43,00,000 (a)

(b) Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).
<table>
<thead>
<tr>
<th>Year</th>
<th>MLP inclusive of URV ₹</th>
<th>Internal rate of return (Discount factor @ 15%)</th>
<th>Present Value ₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>8,00,000</td>
<td>0.8696</td>
<td>6,95,680</td>
</tr>
<tr>
<td>2</td>
<td>8,00,000</td>
<td>0.7561</td>
<td>6,04,880</td>
</tr>
<tr>
<td>3</td>
<td>8,00,000</td>
<td>0.6575</td>
<td>5,26,000</td>
</tr>
<tr>
<td>4</td>
<td>8,00,000</td>
<td>0.5718</td>
<td>4,57,440</td>
</tr>
<tr>
<td>5</td>
<td>8,00,000</td>
<td>0.4972</td>
<td>3,97,760</td>
</tr>
<tr>
<td>1,60,000 (GRV)</td>
<td></td>
<td>0.4972</td>
<td>79,552</td>
</tr>
<tr>
<td>41,60,000</td>
<td></td>
<td></td>
<td>27,61,312 (i)</td>
</tr>
<tr>
<td>1,40,000 (URV)</td>
<td></td>
<td>0.4972</td>
<td>69,608 (ii)</td>
</tr>
<tr>
<td>43,00,000</td>
<td>(i)+ (ii)</td>
<td></td>
<td>28,30,920 (b)</td>
</tr>
</tbody>
</table>

**Unearned Finance Income (a) - (b) = ₹ 43,00,000 – ₹ 28,30,920= ₹ 14,69,080.**

**Manufacturer or dealer lessor**

The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

**Disclosures**

The lessor should make the following disclosures for finance leases:

(a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

(i) not later than one year;
(ii) later than one year and not later than five years;
(iii) later than five years;

(b) unearned finance income;

(c) the unguaranteed residual values accruing to the benefit of the lessor;
(d) the accumulated provision for uncollectible minimum lease payments receivable;
(e) contingent rents recognised in the statement of profit and loss for the period;
(f) a general description of the significant leasing arrangements of the lessor; and
(g) accounting policy adopted in respect of initial direct costs.

**Note:** The Level II and Level III non-corporate entities (and SMCs) need not make disclosures required by (a) and (f) above.

**Accounting for Operating Leases**

**Accounting treatment in the Books of lessee**

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of a lessee on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user’s benefit.

Lease payments may be tailor made to suit the payment capacity of the lessee. For example, a lease term may provide for low initial rents and high terminal rent. Such payment patterns do not reflect the pattern of benefit derived by the lessee from the use of leased asset. To have better matching between revenue and costs, AS 19 requires lessees to recognise operating lease payments as expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user’s benefit.

*Suppose outputs from a machine taken on a 3 year operating lease are estimated as 10,000 units in year 1, 20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are ₹ 25,000, ₹ 45,000 and ₹ 50,000 respectively. The total lease payment ₹ 1,20,000 in this example should be recognised in proportion of output as ₹ 15,000 in year 1, ₹ 30,000 in year 2 and ₹ 75,000 in year 3. The difference between lease rent due and lease rent recognised can be debited / credited to Lease Equalisation A/c.*

*The accounting entries for year 1 in books of lessee are suggested below:*

<table>
<thead>
<tr>
<th>Description</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease Rent A/c Dr.</td>
<td>25,000</td>
</tr>
<tr>
<td>To Lessor</td>
<td>25,000</td>
</tr>
<tr>
<td>(Being lease rent for the year due)</td>
<td>25,000</td>
</tr>
</tbody>
</table>
Since total lease rent due and recognised must be same, the Lease Equalisation A/c will close in the terminal year. Till then, the balance of Lease Equalisation A/c can be shown in the balance sheet under “Current Assets” or “Current Liabilities” depending on the nature of balance.

**Disclosures by lessees**

The paragraph 25 requires lessees to make following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancelable operating leases for each of the following periods:
   (i) not later than one year;
   (ii) later than one year and not later than five years;
   (iii) later than five years;

(b) the total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date;

(c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

(d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

(e) a general description of the lessee’s significant leasing arrangements including, but not limited to, the following:
   (i) the basis on which contingent rent payments are determined;
   (ii) the existence and terms of renewal or purchase options and escalation clauses; and
   (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.
Note: The Level II and Level III non-corporate entities (and SMCs) need not make disclosures required by (a), (b) and (e) above.

Accounting treatment in the books of lessor

(i) The lessor should present an asset given under operating lease as fixed assets in its balance sheets.

(ii) Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

(iii) Depreciation should be recognised in the books of lessor. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 10.

(iv) The impairment losses on assets given on operating leases are determined and treated as per AS 28.

A manufacturer or dealer lessor should recognise the asset given on operating lease as fixed asset in their books by debiting concerned Fixed Asset A/c and crediting Cost of Production / Purchase at cost. No selling profit should be recognised on entering into operating lease, because such leases are not equivalents of sales.

Suppose outputs from a machine of economic life of 6 years are estimated as 10,000 units in year 1, 20,000 units in year 2 and 30,000 units in year 3, 40,000 units in year 4, 20,000 units in year 5 and 5,000 units in year 6. The machine was given on 3-year operating lease by a dealer of the machine for equal annual lease rentals to yield 20% profit margin on cost ₹ 5,00,000. Straight-line depreciation in proportion of output is considered appropriate.

\[
\text{Total lease rent} = 120\% \text{ of } ₹ 5 \text{ lakhs} \times \frac{\text{Output during lease period}}{\text{Total output}}
\]

\[
= ₹ 6 \text{ lakhs} \times \frac{60,000 \text{ units}}{1,25,000 \text{ units}} = ₹ 2.88 \text{ lakhs}
\]

Annual lease rent = ₹ 2,88,000 / 3 = ₹ 96,000

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 10 : 20 : 30. Hence income recognised in years 1, 2 and 3 are ₹ 48,000, ₹ 96,000 and ₹ 1,44,000 respectively.
Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 5 lakh should be allocated over useful life 6 years in proportion of output, i.e. in proportion of 10 : 20 : 30 : 40 : 20 : 5. Depreciation for year 1 is ₹ 40,000.

The accounting entries for year 1 in books of lessor are suggested below:

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine given on Operating Lease</td>
<td>Dr. 5,00,000</td>
<td>5,00,000</td>
</tr>
<tr>
<td>(Being machine given on operating lease brought into books)</td>
<td>To Purchase</td>
<td></td>
</tr>
<tr>
<td>Lessee</td>
<td>Dr. 96,000</td>
<td>96,000</td>
</tr>
<tr>
<td>(Being lease rent for the year due)</td>
<td>To Lease Rent</td>
<td></td>
</tr>
<tr>
<td>Bank</td>
<td>Dr. 96,000</td>
<td>96,000</td>
</tr>
<tr>
<td>(Being receipt of lease rent for the year)</td>
<td>To Lessee</td>
<td></td>
</tr>
<tr>
<td>Lease Rent</td>
<td>Dr. 96,000</td>
<td>96,000</td>
</tr>
<tr>
<td>(Being recognition of lease rent as income for the year)</td>
<td>To P &amp; L A/c</td>
<td>48,000</td>
</tr>
<tr>
<td></td>
<td>To Lease Equalisation A/c</td>
<td>48,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>Dr. 40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>(Being depreciation for the year)</td>
<td>To Machine given on Operating Lease</td>
<td>40,000</td>
</tr>
<tr>
<td>P &amp; L A/c</td>
<td>Dr. 40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>(Being depreciation for the year transferred to P &amp; L A/c)</td>
<td>To Depreciation</td>
<td></td>
</tr>
</tbody>
</table>

Since total lease rent due and recognised must be same, the Lease Equalisation A/c will close in the terminal year. Till then, the balance of Lease Equalisation A/c can be shown in the balance sheet under "Current Assets" or Current Liabilities" depending on the nature of balance.
Disclosures by lessors

As per AS 19, the lessor should, in addition to the requirements of AS 10 (Revised) and the governing statute, make the following disclosures for operating leases:

(a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and
  (i) the depreciation recognised in the statement of profit and loss for the period;
  (ii) impairment losses recognised in the statement of profit and loss for the period;
  (iii) impairment losses reversed in the statement of profit and loss for the period;

(b) the future minimum lease payments under non-cancelable operating leases in the aggregate and for each of the following periods:
  (i) not later than one year;
  (ii) later than one year and not later than five years;
  (iii) later than five years;

(c) total contingent rents recognised as income in the statement of profit and loss for the period;

(d) a general description of the lessor’s significant leasing arrangements; and
(e) accounting policy adopted in respect of initial direct costs.

Note: The Level II and Level III non-corporate entities (and SMCs) need not make disclosures required by (b) and (d) above.

Sale and Leaseback

The basis of a sale and leaseback agreement is simply that one sells an asset for cash and then leases it back from the buyer. The asset subject to such sale and leaseback agreement is generally property. Under such an agreement the property owner agrees to sell the property at an agreed valuation and lease it back from the buyer. The lessee or seller receives cash immediately and makes periodic payment in form of lease rents for right to use the property. The lease payments and the sale price are generally interdependent as they are negotiated as a package. The accounting treatment of a sale and lease back depends upon the type of lease involved. Accounting treatment of profits / losses on sale of
asset, as required by the standard in respect of sale and lease-back transactions, are summarised below.

- **Where sale and leaseback results in finance lease**
  The excess or deficiency of sales proceeds over the carrying amount should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

- **Where sale and leaseback results in operating lease**

  **Case 1:** Sale price = Fair Value
  Profit or loss should be recognised immediately.

  **Case 2:** Sale Price < Fair Value
  Profit should be recognised immediately. The loss should also be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.

  **Case 3:** Sale Price > Fair Value
  The excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

**Illustration 3**
A Ltd. sold machinery having WDV of ₹40 lakhs to B Ltd. for ₹50 lakhs and the same machinery was leased back by B Ltd. to A Ltd. The lease back is operating lease. Comment if –

(a) Sale price of ₹50 lakhs is equal to fair value.
(b) Fair value is ₹60 lakhs.
(c) Fair value is ₹45 lakhs and sale price is ₹38 lakhs.
(d) Fair value is ₹40 lakhs and sale price is ₹50 lakhs.
(e) Fair value is ₹46 lakhs and sale price is ₹50 lakhs.
(f) Fair value is ₹35 lakhs and sale price is ₹39 lakhs.

**Solution**
Following will be the treatment in the given cases:

(a) When sales price of ₹50 lakhs is equal to fair value, A Ltd. should immediately recognise the profit of ₹10 lakhs (i.e. 50 – 40) in its books.
(b) When fair value is ₹ 60 lakhs then also profit of ₹10 lakhs should be immediately recognised by A Ltd.

(c) When fair value of leased machinery is ₹ 45 lakhs & sales price is ₹ 38 lakhs, then loss of ₹ 2 lakhs (40 – 38) to be immediately recognised by A Ltd. in its books provided loss is not compensated by future lease payment.

(d) When fair value is ₹ 40 lakhs & sales price is ₹ 50 lakhs then, profit of ₹ 10 lakhs is to be deferred and amortised over the lease period.

(e) When fair value is ₹ 46 lakhs & sales price is ₹ 50 lakhs, profit of ₹ 6 lakhs (46 - 40) to be immediately recognised in its books and balance profit of ₹4 lakhs (50-46) is to be amortised/deferred over lease period.

(f) When fair value is ₹ 35 lakhs & sales price is ₹ 39 lakhs, then the loss of ₹ 5 lakhs (40-35) to be immediately recognised by A Ltd. in its books and profit of ₹ 4 lakhs (39-35) should be amortised/deferred over lease period.

2.6 AS 20: EARNINGS PER SHARE

Introduction

The objective of AS 20 is to describe principles for determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.

Earnings per share (EPS) is a financial ratio indicating the amount of profit or loss for the period attributable to each equity share and AS 20 gives computational methodology for determination and presentation of basic and diluted earnings per share.

This Accounting Standard is mandatory for all companies. However, disclosure of diluted earnings per share (both including and excluding extraordinary items) is not mandatory for SMCs. Such companies are however encouraged to make these disclosures.

In consolidated financial statements, the information required by AS 20 should be presented on the basis of consolidated information.

Definition of the terms used in AS 20

An equity share is a share other than a preference share.

A preference share is a share carrying preferential rights to dividends and repayment of capital.
A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

A financial asset is any asset that is

a. Cash;
b. A contractual right to receive cash or another financial asset from another enterprise;
c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or
d. An equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

Examples of potential equity shares are:

a. Debt instruments or preference shares, that are convertible into equity shares;
b. Share warrants;
c. Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and
d. Shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.

Basic Earnings Per Share
Basic earnings per share is calculated as
APPLICATION OF ACCOUNTING STANDARDS

Net profit (loss) attributable to equity shareholders
Weighted average number of equity shares outstanding during the period

Earnings- Basic

All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless AS 5 requires or permits otherwise.

The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

The amount of preference dividends for the period that is deducted from the net profit for the period is:

a. The amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

b. The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

Per share- Basic

The number of shares used in the denominator for basic EPS should be the weighted average number of equity shares outstanding during the period.

The weighted average number of equity shares outstanding during the period is the number of shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by a time-weighting factor.

The time-weighting factor is:

\[
\frac{\text{Numbers of days the shares are outstanding}}{\text{Number of days in the period}}
\]
Although the Standard defines the time-weighting factor as being determined on a daily basis, it acknowledges that a reasonable approximation of the weighted average is adequate in many circumstances.

**Illustration 1**

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Purchased</th>
<th>Sold</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st January</td>
<td>Balance at beginning of year</td>
<td>1,800</td>
<td>-</td>
<td>1,800</td>
</tr>
<tr>
<td>31st May</td>
<td>Issue of shares for cash</td>
<td>600</td>
<td>-</td>
<td>2,400</td>
</tr>
<tr>
<td>1st November</td>
<td>Buy Back of shares</td>
<td>-</td>
<td>300</td>
<td>2,100</td>
</tr>
</tbody>
</table>

*Calculate Weighted Number of Shares.*

**Solution**

Computation of Weighted Average:

\[(1,800 \times 5/12) + (2,400 \times 5/12) + (2,100 \times 2/12) = 2,100 \text{ shares.}\]

The weighted average number of shares can alternatively be computed as follows:

\[(1,800 \times 12/12) + (600 \times 7/12) - (300 \times 2/12) = 2,100 \text{ shares}\]

In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

a. Equity shares issued in exchange for cash are included when cash is receivable;

b. Equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

c. Equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

d. Equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

e. Equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

f. Equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due
consideration should be given to the substance of any contract associated with the issue.

Equity shares issued as part of the consideration in an amalgamation in the nature of purchase are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued as part of the consideration in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Illustration 2

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>No. of Share</th>
<th>Face Value</th>
<th>Paid up Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st January</td>
<td>Balance at</td>
<td>1,800</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>beginning of year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31st October</td>
<td>Issue of Shares</td>
<td>600</td>
<td>10</td>
<td>5</td>
</tr>
</tbody>
</table>

Calculate Weighted Number of Shares.

Solution

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

\[ (1,800 \times 12/12) + (300 \times 2/12) = 1,850 \text{ shares} \]

Where an enterprise has equity shares of different nominal values but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.
Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

a. A bonus issue;
b. A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;
c. A share split; and
d. A reverse share split (consolidation of shares).

In case of a **bonus issue or a share split**, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. For example, upon a two-for-one bonus issue, the number of shares outstanding prior to the issue is multiplied by a factor of three to obtain the new total number of shares, or by a factor of two to obtain the number of additional shares.

**Illustration 3**

*Net profit for the year 2016  ₹ 18,00,000*
*Net profit for the year 2017  ₹ 60,00,000*
*No. of equity shares outstanding until 30th September 2017  20,00,000*

*Bonus issue 1st October 2017 was 2 equity shares for each equity share outstanding at 30th September, 2017*

*Calculate Basic Earnings Per Share.*

**Solution**

No. of Bonus Issue 20,00,000 x 2 = 40,00,000 shares

\[
\text{Earnings per share for the year 2017 } = \frac{₹ 60,00,000}{(20,00,000 + 40,00,000)} = ₹ 1.00
\]
Adjusted earnings per share for the year 2016: 
\[
\frac{\text{₹} 18,00,000}{(20,00,000 + 40,00,000)} = \text{₹} 0.30
\]

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2016, the earliest period reported.

The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. In a rights issue, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

\[
\text{Fair value per share immediately prior to the exercise of rights}
\]
\[
\text{Theoretical ex-rights fair value per share}
\]

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights.

**Illustration 4**

*Net profit for the year 2016*  
\text{₹} 11,00,000

*Net profit for the year 2017*  
\text{₹} 15,00,000

*No. of shares outstanding prior to rights issue*  
5,00,000 shares

*Rights issue price*  
\text{₹} 15.00

*Last date to exercise rights*  
1\textsuperscript{st} March 2017

*Rights issue is one new share for each five outstanding (i.e. 1,00,000 new shares)*

*Fair value of one equity share immediately prior to exercise of rights on 1\textsuperscript{st} March 2017 was*  
\text{₹} 21.00.  
*Compute Basic Earnings Per Share.*

**Solution**

\[
\text{Fair value of shares immediately prior to exercise of rights + Total amount received from exercise}
\]
\[
\frac{\text{(₹ 21.00 × 5,00,000 shares) + (₹ 15.00 × 1,00,000 Shares)}}{5,00,000 Shares + 1,00,000 Shares}
\]
Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor:

\[
\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{₹ 21.00}{₹ 20.00} = 1.05
\]

Computation of earnings per share:

EPS for the year 2016 as originally reported: ₹ 11,00,000/5,00,000 shares = ₹ 2.20

EPS for the year 2016 restated for rights issue: ₹ 11,00,000/ (5,00,000 shares x 1.05) = ₹ 2.10

EPS for the year 2017 including effects of rights issue:

\[
(5,00,000 \times 1.05 \times 2/12) + (6,00,000 \times 10/12) = 5,87,500 \text{ shares}
\]

\[
\text{EPS} = 15,00,000/5,87,500 = ₹ 2.55
\]

**Diluted Earnings Per Share**

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

a. The net profit for the period attributable to equity shares is:

   i. Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; 

   ii. Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and

   iii. Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

b. The weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

For the purpose of AS 20, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.
**Earnings- Diluted**

For the purpose of calculating diluted earnings per share, the amount of net profit or loss for the period attributable to equity shareholders, should be adjusted by the following, after taking into account any attributable change in tax expense for the period:

(a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders;

(b) interest recognised in the period for the dilutive potential equity shares; and

(c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in Basic Earnings Per Share is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

**Illustration 5**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net profit for the current year</strong></td>
<td>₹ 1,00,00,000</td>
</tr>
<tr>
<td><strong>No. of equity shares outstanding</strong></td>
<td>50,00,000</td>
</tr>
<tr>
<td><strong>Basic earnings per share</strong></td>
<td>₹ 2.00</td>
</tr>
<tr>
<td><strong>No. of 12% convertible debentures of ₹ 100 each</strong></td>
<td>1,00,000</td>
</tr>
<tr>
<td><strong>Each debenture is convertible into 10 equity shares</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Interest expense for the current year</strong></td>
<td>₹ 12,00,000</td>
</tr>
<tr>
<td><strong>Tax relating to interest expense (30%)</strong></td>
<td>₹ 3,60,000</td>
</tr>
</tbody>
</table>

**Compute Diluted Earnings Per Share.**

**Solution**

Adjusted net profit for the current year (1,00,00,000 + 12,00,000 − 3,60,000) = ₹ 1,08,40,000

No. of equity shares resulting from conversion of debentures: 10,00,000 Shares

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No. of equity shares used to compute diluted EPS: \((50,00,000 + 10,00,000)\) 
\(= 60,00,000\) Shares  
Diluted earnings per share: \(\frac{1,08,40,000}{60,00,000}\) = ₹ 1.81  

**Per share - Diluted**

For the purpose of calculating diluted earnings per share, the number of equity shares should be the aggregate of the weighted average number of equity shares, and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no
Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

a. A contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

b. A contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

### Illustration 6

| Net profit for the year 2017 | ₹ 12,00,000 |
| Weighted average number of equity shares outstanding during the year 2017 | 5,00,000 shares |
| Average fair value of one equity share during the year 2017 | ₹ 20.00 |
| Weighted average number of shares under option during the year 2017 | 1,00,000 shares |
| Exercise price for shares under option during the year 2017 | ₹ 15.00 |

**Compute Basic and Diluted Earnings Per Share.**

**Solution**

**Computation of earnings per share**

<table>
<thead>
<tr>
<th>Earnings</th>
<th>Shares</th>
<th>Earnings/Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>₹</td>
<td>₹</td>
<td>₹</td>
</tr>
<tr>
<td>Net profit for the year 2017</td>
<td>12,00,000</td>
<td>5,00,000</td>
</tr>
<tr>
<td>Weighted average no. of shares during year 2017</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic earnings per share</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of shares under option</td>
<td>1,00,000</td>
<td></td>
</tr>
<tr>
<td>Number of shares that would have</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
been issued at
fair value (100,000 x 15.00)/20.00  (75,000)
Diluted earnings per share  12,00,000  5,25,000  2.29

Note: The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration.

To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of warrants or options.

**Dilutive Potential Equity Shares**

Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

In considering whether potential equity shares are dilutive or antidilutive, each issue or series of potential equity shares is considered separately rather than in aggregate. The sequence in which potential equity shares are considered may affect whether or not they are dilutive. Therefore, in order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Potential equity shares are weighted for the period they were outstanding. Potential equity shares that were cancelled or allowed to lapse during the reporting period are included in the computation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential equity shares that have been converted into equity shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting equity shares are included in computing both basic and diluted earnings per share.
Restatement

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

Presentation

An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

AS 20 requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

Disclosure

An enterprise should disclose the following:

a. Where the statement of profit and loss includes extraordinary items (as defined is AS 5), basic and diluted EPS computed on the basis of earnings excluding extraordinary items (net of tax expense);
b. The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;
c. The weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and
d. The nominal value of shares along with the earnings per share figures.

If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with AS 20. If a component of net profit is used which is not reported
as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

### 2.7 AS 24: DISCONTINUING OPERATIONS

**Introduction**

AS 24 is applicable to all discontinuing operations.

The objective of AS 24 is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

**Discontinuing Operation**

A discontinuing operation is a component of an enterprise:

a. That the enterprise, pursuant to a single plan, is:
   
   (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or
   
   (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or
   
   (iii) Terminating through abandonment and

b. That represents a separate major line of business or geographical area of operations.

c. That can be distinguished operationally and for financial reporting purposes.

A reportable business segment or geographical segment as defined in AS 17 ‘Segment Reporting’, would normally satisfy criterion (b) of the above definition, that is, it would represent a separate major line of business or geographical area of operations. A part or such a segment may also satisfy criterion (b) of the above definition. For an enterprise that operates in a single business or geographical segment and, therefore, does not report segment information, a major product or service line may also satisfy the criteria of the definition.

Instead of disposing of a component substantially in its entirety, an enterprise
may discontinue and dispose of the component by selling its assets and settling its liabilities piecemeal (individually or in small groups). For piecemeal disposals, while the overall result may be a net gain or a net loss, the sale of an individual asset or settlement of an individual liability may have the opposite effect. Moreover, there is no specific date at which an overall binding sale agreement is entered into. Rather, the sales of assets and settlements of liabilities may occur over a period of months or perhaps even longer. Thus, disposal of a component may be in progress at the end of a financial reporting period. To qualify as a discontinuing operation, the disposal must be pursuant to a single coordinated plan.

An enterprise may terminate an operation by abandonment without substantial sales of assets. An abandoned operation would be a discontinuing operation if it satisfies the criteria in the definition. However, changing the scope of an operation or the manner in which it is conducted is not abandonment because that operation, although changed, is continuing.

Examples of activities that do not necessarily satisfy criterion (a) of the definition, but that might do so in combination with other circumstances, include:

a. Gradual or evolutionary phasing out of a product line or class of service.
b. Discontinuing, even if relatively abruptly, several products within an ongoing line of business.
c. Shifting of some production or marketing activities for a particular line of business from one location to another and
d. Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation - if all the following conditions are met:

a. The operating assets and liabilities of the component can be directly attributed to it.
b. Its revenue can be directly attributed to it.
c. At least a majority of its operating expenses can be directly attributed to it.

Assets, liabilities, revenue, and expenses are directly attributable to a component
if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it.

Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations.

The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under AS 24 does not, in itself, bring into question the enterprise’s ability to continue as a going concern.

**Initial Disclosure event**

With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

a. The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation or

b. The enterprise's board of directors or similar governing body has both

   (i) approved a detailed, formal plan for the discontinuance and

   (ii) made an announcement of the plan.

A detailed, formal plan for the discontinuance normally includes:

- identification of the major assets to be disposed of;
- the expected method of disposal;
- the period expected to be required for completion of the disposal;
- the principal locations affected;
- the location, function, and approximate number or employees who will be compensated for terminating their services; and
- the estimated proceeds or salvage to be realised by disposal.

An enterprise’s board of directors or similar governing body is considered to have made the announcement of a detailed, formal plan for discontinuance, if it has announced the main features of the plan to those affected by it, such as, lenders, stock exchanges, trade payables, trade unions, etc. in a sufficiently specific manner so as to make the enterprise demonstrably committed to the discontinuance.

**Recognition and Measurement**

For recognising and measuring the effect of discontinuing operations, this AS
does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.

**Presentation and Disclosure**

**Initial Disclosure**

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

a. A description of the discontinuing operation(s)

b. The business or geographical segment(s) in which it is reported as per AS 17

c. The date and nature of the initial disclosure event.

d. The date or period in which the discontinuance is expected to be completed if known or determinable

e. The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled

f. The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period

g. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto

h. The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period

**Disclosures other than Initial Disclosures Note**

All the disclosures above should be presented in the notes to the financial statements except for amounts pertaining to pre-tax profit/loss of the discontinuing operation and the income tax expense thereon (second last bullet above) which should be shown on the face of the statement of profit and loss.

**Other disclosures**

When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:
a. For any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss and

b. The net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

**Updating the disclosures**

In addition to these disclosures, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes.

The disclosures should continue in financial statements for periods up to and including the period in which the discontinuance is completed. Discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received.

If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefore and its effect should be disclosed.

**Separate disclosure for each discontinuing operation**

Any disclosures required by AS 24 should be presented separately for each discontinuing operation.

**Presentation of the required disclosures**

The above disclosures should be presented in the notes to the financial statements except the following which should be shown on the face of the statement of profit and loss:

a. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto and

b. The amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.

**Restatement of prior periods**
Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that mentioned above.

**Disclosure in interim financial reports**

Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25, ‘Interim Financial Reporting’, including:

a. Any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation and

b. Any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.

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**2.8 AS 26: INTANGIBLE ASSETS**

**Introduction**

The objective of AS 26 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. AS 26 requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. AS 26 also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

**Scope**

AS 26 should be applied by all enterprises in accounting for intangible assets, except:

a. Intangible assets that are covered by another Accounting Standard

For example, AS 26 does not apply to:

(a) intangible assets held by an enterprise for sale in the ordinary course of business (AS 2 and AS 7)

(b) deferred tax assets (AS 22)

(c) leases that fall within the scope of AS 19

(d) goodwill arising on an amalgamation (AS 14 (Revised)) and goodwill arising on consolidation (AS 21 (Revised))

b. Financial assets.
c. Mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources and

d. Intangible assets arising in insurance enterprises from contracts with policyholders.

However, AS 26 applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises.

**AS 26 also applies to:**

(i) expenditure on advertising, training, start-up cost  
(ii) Research and development activities  
(iii) Right under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts  
(iv) Patents, copyrights and trademarks  
(v) goodwill

**Definitions**

**An asset** is a resource:

a. Controlled by an enterprise as a result of past events and

b. From which future economic benefits are expected to flow to the enterprise.

**Monetary assets** are money held and assets to be received in fixed or determinable amounts of money.

**Non-monetary assets** are assets other than monetary assets.

**Amortisation** is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

**Depreciable amount** is the cost of an asset less its residual value.

**Useful life** is either:

(a) the period of time over which an asset is expected to be used by the enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by the enterprise.
**APPLICATION OF ACCOUNTING STANDARDS**

**Fair value** of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction.

**An active market** is a market where all the following conditions exist:

a. The items traded within the market are homogeneous.

b. Willing buyers and sellers can normally be found at any time and

c. Prices are available to the public.

**An impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

**Carrying amount** is the amount at which an asset is recognised in the balance sheet, net of any accumulated amortisation and accumulated impairment losses thereon.

**A financial asset** is any asset that is:

a. Cash,

b. A contractual right to receive cash or another financial asset from another enterprise,

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable or

d. An ownership interest in another enterprise.

**Intangible Assets**

An intangible asset is

- an identifiable
- non-monetary asset
- without physical substance
- held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer
loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

Not all the items described above will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by AS 26 does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Identifiability

- The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill.

- An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

- Though Separability is not a necessary condition for identifiability. If an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.
**Control**

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement or by a legal duty on employees to maintain confidentiality.

Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise as employees may leave the enterprise anytime or even loyal customers may decide to purchase goods and services from other suppliers. Hence, these items don’t even qualify as intangible asset as per the definition given in AS 26.

**Future Economic Benefits**

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

**Recognition and Initial Measurement of an Intangible Asset**

The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the definition of an intangible asset and recognition criteria set out as below:

a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

b. The cost of the asset can be measured reliably.

An intangible asset should be measured initially at cost.

An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.
An intangible asset should be measured initially at cost.

**Separate Acquisition**

If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

**Acquisition as part of an Amalgamation**

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with AS 14 (Revised). In accordance with AS 26:

a. A transferee recognises an intangible asset that meets the recognition criteria, even if that intangible asset had not been recognised in the financial statements of the transferor and

b. If the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill.

Hence, judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an
arm's length transaction between knowledgeable and willing parties, based on the best information available. The cost initially recognised for the intangible asset in this case is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

**Acquisition by way of a Government Grant**

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources. AS 12, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

**Exchanges of assets**

An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10.

**Internally generate goodwill**

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

**Internally Generated Intangible Assets**

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into

- Research Phase
- Development Phase

If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.
Research Phase

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

No intangible asset arising from research or from the research phase should be recognised. Expenditure on research or on the research phase should be recognised as an expense when it is incurred.

Examples of research activities are:

a. Activities aimed at obtaining new knowledge.

b. The search for, evaluation and final selection of, applications of research findings or other knowledge.

c. The search for alternatives for materials, devices, products, processes, systems or services;

d. The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.

b. Its intention to complete the intangible asset and use or sell it.

c. Its ability to use or sell the intangible asset.

d. How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

e. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset and
f. Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Examples of development activities are:

a. The design, construction and testing of pre-production or pre-use prototypes and models.

b. The design of tools, jigs, moulds and dies involving new technology.

c. The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production and
d. The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

An enterprise assesses the future economic benefits to be received from the asset using the principles in AS 28 on ‘Impairment of Assets’.

AS 26 takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

**Cost of an Internally Generated Intangible Asset**

The cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria. Reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports is prohibited.

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the recognition criteria. The cost includes, if applicable:

a. Expenditure on materials and services used or consumed in generating the intangible asset.

b. The salaries, wages and other employment related costs of personnel directly engaged in generating the asset.

c. Any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licenses that are used to generate the asset and
d. Overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset. Allocations of overheads are made on bases similar to those discussed in AS 2 & AS 16.

The following are not components of the cost of an internally generated intangible asset:

a. Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use.

b. Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance and

c. Expenditure on training the staff to operate the asset.

**Example**

*An enterprise is developing a new production process. During the year 20X1, expenditure incurred was ₹ 10 lacs, of which ₹ 9 lacs was incurred before 1 December 20X1 and 1 lac was incurred between 1 December 20X1 and 31 December 20X1. The enterprise is able to demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 5 lacs.*

*At the end of 20X1, the production process is recognised as an intangible asset at a cost of ₹ 1 lac (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X1). The ₹ 9 lacs expenditure incurred before 1 December 20X1 is recognised as an expense because the recognition criteria were not met until 1 December 20X1. This expenditure will never form part of the cost of the production process recognised in the balance sheet.*

*During the year 20X2, expenditure incurred is ₹ 20 lacs. At the end of 20X2, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 19 lacs.*

*At the end of the year 20X2, the cost of the production process is ₹ 21 lacs (₹ 1 lac expenditure recognised at the end of 20X1 plus ₹ 20 lacs expenditure recognised in 20X2). The enterprise recognises an impairment loss of ₹ 2 lacs to adjust the carrying amount of the process before impairment loss (₹ 21 lacs) to its recoverable amount (₹ 19 lacs). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in AS 28, are met.*
Recognition of an Expense
Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

a. It forms part of the cost of an intangible asset that meets the recognition criteria or
b. The item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. It forms part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred. Examples of other expenditure that is recognised as an expense when it is incurred include:

(a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);
(b) expenditure on training activities;
(c) expenditure on advertising and promotional activities; and
(d) expenditure on relocating or re-organising part or all of an enterprise.

The above guidance does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Expenses recognised as expenses cannot be reclassified as cost of intangible asset in later years.

Subsequent Expenditure
Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

a. It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and
b. The expenditure can be measured and attributed to the asset reliably. If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance is always recognised as an expense to avoid the recognition of internally generated goodwill.

**Measurement subsequent to initial recognition**

After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

**Amortisation Period**

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use.

Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. AS 26 adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

a. Amortises the intangible asset over the best estimate of its useful life.

b. Estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss and

c. Discloses the reasons why the presumption is rebutted and the factors that played a significant role in determining the useful life of the asset.

**Examples**

_A. An enterprise has purchased an exclusive right to generate hydroelectric power for 60 years. The costs of generating hydro-electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least 60 years._

_The enterprise amortises the right to generate power over 60 years, unless there is evidence that its useful life is shorter._
B. An enterprise has purchased an exclusive right to operate a toll motorway for 30 years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least 30 years.

The enterprise amortises the right to operate the motorway over 30 years, unless there is evidence that its useful life is shorter.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless the legal rights are renewable and renewal is virtually certain.

There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

**Amortisation Method**

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.

The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories.

**Residual Value**

Residual value is the amount, which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

The residual value of an intangible asset should be assumed to be zero unless:

a. There is a commitment by a third party to purchase the asset at the end of its useful life or
b. There is an active market for the asset and:
   i. Residual value can be determined by reference to that market and
   ii. It is probable that such a market will exist at the end of the asset's useful life.

Review of amortisation period and amortisation method

The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5.

Recoverability of the Carrying Amount—Impairment Losses

Impairment losses of intangible assets are calculated on the basis of AS 28. AS 28 “Impairment of Assets” is not covered under IPCC curriculum and will be discussed in the Final level of CA course.

Retirements and Disposals

An intangible asset should be derecognised (eliminated from the balance sheet) if
- disposed or
- when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

Disclosure

The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:
1. The useful lives or the amortisation rates used.
2. The amortisation methods used.
3. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.
4. A reconciliation of the carrying amount at the beginning and end of the period showing:
   I. Additions, indicating separately those from internal development and through amalgamation.
   II. Retirements and disposals.
   III. Impairment losses recognised in the statement of profit and loss during the period.
   IV. Impairment losses reversed in the statement of profit and loss during the period.
   V. Amortisation recognised during the period and
   VI. Other changes in the carrying amount during the period.

**Other Disclosures**

The financial statements should also disclose:

a. If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset.

b. A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole.

c. The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and

d. The amount of commitments for the acquisition of intangible assets.

The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

**Illustration 1**

*ABC Ltd. developed know-how by incurring expenditure of ₹ 20 lakhs, The know-how was used by the company from 1.4.2009. The useful life of the asset is 10 years from the year of commencement of its use. The company has not amortised the asset till 31.3.2016. Pass Journal entry to give effect to the value of know-how as per Accounting Standard-26 for the year ended 31.3.2016.***
Solution

### Journal Entry

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<td>To Know-how A/c</td>
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<tr>
<td>[Being depreciation of 7 years (out of which depreciation of 6 years charged as prior period item)]</td>
<td></td>
<td>14,00,000</td>
</tr>
</tbody>
</table>

Illustration 2

*The company had spent ₹ 45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 2015-2016, but proved to be a failure. State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 2016.*

**Solution**

In the given case, the company spent ₹ 45 lakhs for publicity and research of a new product which was marketed but proved to be a failure. It is clear that in future there will be no related further revenue/benefit because of the failure of the product. Thus according to AS 26 ‘Intangible Assets’, the company should charge the total amount of ₹ 45 lakhs as an expense in the profit and loss account.

Illustration 3

*A company with a turnover of ₹ 250 crores and an annual advertising budget of ₹ 2 crores had taken up the marketing of a new product. It was estimated that the company would have a turnover of ₹ 25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of ₹ 2 crore incurred on extensive special initial advertisement campaign for the new product. Is the procedure adopted by the company correct?*

*As per para 63 of AS 26 "Intangible Assets", there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.*

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Solution
According to AS 26 ‘Intangible Assets’, “expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset”.

AS 26 mentions that expenditure on advertising and promotional activities should be recognised as an expense when incurred.

In the given case, advertisement expenditure of ₹ 2 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of ₹ 25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised. Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of ₹ 2 crores to the Profit and Loss account of the year is correct.

2.9 AS 29 (REVISED): PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Introduction
AS 29 (Revised) came into effect in respect of accounting periods commenced on or after 1-4-2004. The objective of AS 29 (Revised) is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The objective of AS 29 (Revised) is also to lay down appropriate accounting for contingent assets.

Scope
AS 29 should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, other than
a. Those resulting from financial instruments that are carried at fair value;
b. Those resulting from executory contracts except where the contract is onerous;
c. Those arising in insurance enterprises from contracts with policy-holders; and
d. Those covered by another Accounting Standard.

Where another Accounting Standard such as AS 7; AS 9; AS 15; AS 19 and AS 22 deals with a specific type of provision, contingent liability or contingent asset, an
Definitions

**Executory contracts** are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

**A Provision** is a liability which can be measured only by using a substantial degree of estimation.

**A Liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

**An Obligating event** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

**A Contingent liability is:**

(a) A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) A present obligation that arises from past events but is not recognised because:

   (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

   (ii) A reliable estimate of the amount of the obligation cannot be made.

**A Contingent asset** is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

**Present obligation** - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

**Possible obligation** - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

**A Restructuring** is a programme that is planned and controlled by management, and materially changes either:
(a) The scope of a business undertaken by an enterprise; or
(b) The manner in which that business is conducted.

**Provisions**

*A provision should be recognised when:*

(a) An enterprise has a present obligation as a result of a past event;
(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
(c) A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

**Present Obligation**

An enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, e.g., the opinion of experts. On the basis of such evidence:

(a) Where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and
(b) Where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

**Past Event**

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow.
of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.

Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

**Probable Outflow of Resources Embodying Economic Benefits**

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of AS 29, an outflow of resources or other event is regarded as probable if the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where there are a number of similar obligations (e.g., product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

**Reliable Estimate of the Obligation**

The use of estimates is an inherent part of preparing financial statements and
does not undermine their reliability. Provisions require a greater degree of estimation than most other items, but AS 29 (Revised) emphasises that it should not be impossible to determine a range of possible outcomes and, from this range, to reach an appropriate conclusion that is sufficiently reliable for the provision to be recognised. AS 29 (Revised) concludes that the circumstances in which it will not be possible to reach a reliable estimate, will be extremely rare.

In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability will, instead, be disclosed as a contingent liability.

**Contingent Liabilities**

An enterprise should not recognise a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs.

**Contingent Assets**

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

An enterprise should not recognise a contingent asset, since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving
authority in the case of any other enterprise), where an inflow of economic benefits is probable.

Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

**Table- Provisions and contingent liabilities**

| Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation the one whose existence at the balance sheet date is considered probable; or (b) a possible obligation the existence of which at the balance sheet date is considered not probable. |
|---|---|---|
| There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation. | There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources. | There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote. |
| A provision is recognised. Disclosures are required for the provision. | No provision is recognised. Disclosures are required for the contingent liability. | No provision is recognised. No disclosure is required. |

**Measurement**

**Best Estimate**

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

The amount of a provision should not be discounted to its present value except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment. The discount rate (or rates) should be a
pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. Periodic unwinding of discount should be recognised in the statement of profit and loss.

The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22.

**Risks and uncertainties**

The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

**Future Events**

It is only those obligations arising from past events that exist independently of the enterprise’s future actions (ie the future conduct of its business) that are recognised as provisions.

Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice usually makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.
Expected Disposal of Assets

Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

Reimbursements

An enterprise with a present obligation may be able to seek reimbursement of part or all of the expenditure from another party, for example via:

- An insurance contract arranged to cover a risk;
- An indemnity clause in a contract; or
- A warranty provided by a supplier.

The basis underlying the recognition of a reimbursement is that any asset arising is separate from the related obligation. Consequently, such a reimbursement should be recognised only when it is virtually certain that it will be received consequent upon the settlement of the obligation.

In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

An obligation for which an enterprise is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

Table - Reimbursements

<table>
<thead>
<tr>
<th>The enterprise has no obligation for the part of the expenditure to be reimbursed</th>
<th>The obligation for the amount expected to be reimbursed remains with</th>
<th>The obligation for the amount expected to be reimbursed remains with</th>
</tr>
</thead>
<tbody>
<tr>
<td>The enterprise has no obligation for the part of the expenditure to be reimbursed remains with</td>
<td>The obligation for the amount expected to be reimbursed remains with</td>
<td>The obligation for the amount expected to be reimbursed remains with</td>
</tr>
<tr>
<td>reimbursed by the other party.</td>
<td>the enterprise and it is virtually certain that reimbursement will be received if the enterprise settles the provision.</td>
<td>the enterprise and the reimbursement is not virtually certain if the enterprise settles the provision.</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>---------------------------------------------------------------</td>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>The enterprise has no liability for the amount to be reimbursed.</td>
<td>The reimbursement is recognised as a separate asset in the balance sheet and may be offset against the expense in the statement of profit and loss. The amount recognised for the expected reimbursement does not exceed the liability.</td>
<td>The expected reimbursement is not recognised as an asset.</td>
</tr>
<tr>
<td>No disclosure is required.</td>
<td>The reimbursement is disclosed together with the amount recognised for the reimbursement.</td>
<td>The expected reimbursement is disclosed.</td>
</tr>
</tbody>
</table>

**Changes in Provisions**
Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

**Use of Provisions**
A provision should be used only for expenditures for which the provision was originally recognised. Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

**Application of the Recognition and Measurement Rules**

**Future Operating Losses**
Future operating losses do not meet the definition of a liability and the general recognition criteria, therefore provisions should not be recognised for future...
operating losses.

**Restructuring**

The following are examples of events that may fall under the definition of restructuring:

(a) Sale or termination of a line of business

(b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another

(c) Changes in management structure, for example, eliminating a layer of management

(d) Fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations

A provision for restructuring costs is recognised only when the recognition criteria for provisions are met. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms.

A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

(a) Necessarily entailed by the restructuring; and

(b) Not associated with the ongoing activities of the enterprise.

A restructuring provision does not include such costs as:

(a) Retraining or relocating continuing staff;

(b) Marketing; or

(c) Investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

Identifiable future operating losses up to the date of a restructuring are not included in a provision.

Gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.
Disclosure

For each class of provision, an enterprise should disclose:

(a) The carrying amount at the beginning and end of the period;
(b) Additional provisions made in the period, including increases to existing provisions;
(c) Amounts used (i.e. incurred and charged against the provision) during the period; and
(d) Unused amounts reversed during the period.

Note: SMCs are exempt from the above disclosure requirements of AS 29 (Revised)

An enterprise should disclose the following for each class of provision:

(a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
(b) An indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, and
(c) The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Note: SMCs are exempt from the above disclosure requirements of AS 29 (Revised)

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

(a) An estimate of its financial effect,
(b) An indication of the uncertainties relating to any outflow; and
(c) The possibility of any reimbursement.

Where any of the information required by above paragraph is not disclosed because it is not practicable to do so, that fact should be stated.

In extremely rare cases, disclosure of some or all of the information required by AS 29 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason
why, the information has not been disclosed.

**Transitional Provisions**

As per the amendment made in AS 29 (Revised) pursuant to MCA notification dated 30 March 2016, effective from financial year 2016-17, all the existing provisions for decommissioning, restoration and similar liabilities should be discounted prospectively, with the corresponding effect to the related item of property, plant and equipment.

**Miscellaneous Illustrations**

**Illustration 1**

At the end of the financial year ending on 31st December, 2017, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

<table>
<thead>
<tr>
<th>Probability</th>
<th>Loss (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>In respect of five cases (Win)</td>
<td>100%</td>
</tr>
<tr>
<td>Next ten cases (Win)</td>
<td>60%</td>
</tr>
<tr>
<td>Lose (Low damages)</td>
<td>30%</td>
</tr>
<tr>
<td>Lose (High damages)</td>
<td>10%</td>
</tr>
<tr>
<td>Remaining five cases</td>
<td></td>
</tr>
<tr>
<td>Win</td>
<td>50%</td>
</tr>
<tr>
<td>Lose (Low damages)</td>
<td>30%</td>
</tr>
<tr>
<td>Lose (High damages)</td>
<td>20%</td>
</tr>
</tbody>
</table>

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof.

**Solution**

According to AS 29 (Revised) ‘Provisions, Contingent Liabilities and Contingent Assets’, contingent liability should be disclosed in the financial statements if following conditions are satisfied:

(i) There is a present obligation arising out of past events but not recognised as provision.

(ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

(iii) The possibility of an outflow of resources embodying economic benefits is not remote.
(iv) The amount of the obligation cannot be measured with sufficient reliability to be recognised as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 60% and for remaining five cases is 50%. As per AS 29 (Revised), we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is remote, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases = 30% of ₹ 1,20,000 + 10% of ₹ 2,00,000
= ₹ 36,000 + ₹ 20,000
= ₹ 56,000

Expected loss in remaining five cases = 30% of ₹ 1,00,000 + 20% of ₹ 2,10,000
= ₹ 30,000 + ₹ 42,000
= ₹ 72,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of ₹ 9,20,000 (₹ 56,000 × 10 + ₹ 72,000 × 5) as contingent liability.

Illustration 2

EXOX Ltd. is in the process of finalising its accounts for the year ended 31st March, 2017. The company seeks your advice on the following:

(i) The Company’s sales tax assessment for assessment year 2014-15 has been completed on 14th February, 2017 with a demand of ₹ 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.

(ii) The Company has entered into a wage agreement in May, 2017 whereby the labour union has accepted a revision in wage from June, 2016. The agreement provided that the hike till May, 2017 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 2017.
Answer

(i) Since the company is not appealing against the addition of ₹ 0.66 crore the same should be provided for in its accounts for the year ended on 31\textsuperscript{st} March, 2017. The amount paid under protest can be kept under the heading ‘Loans & Advances’ and disclosed along with the contingent liability of ₹ 2.10 crore.

(ii) The arrears for the period from June, 2016 to March, 2017 are required to be provided for in the accounts of the company for the year ended on 31\textsuperscript{st} March, 2017.

TEST YOUR KNOWLEDGE

MCQs

1. AB Company Ltd. had 1,00,000 shares of common stock outstanding on January 1. Additional 50,000 shares were issued on July 1, and 25,000 shares were re-acquired on September 1. The weighted average number of shares outstanding during the year on Dec. 31 is
   (a) 1,40,000 shares.
   (b) 1,25,000 shares.
   (c) 1,16,667 shares.

2. A Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs (Fair value ₹ 50 lakhs) and same machinery was leased back by B Ltd. to A Ltd. The lease back is in nature of operating lease. The treatment will be
   (a) A Ltd. should amortise the profit of ₹ 10 lakhs over lease term.
   (b) A Ltd. should recognise the profit of ₹ 10 lakhs immediately.
   (c) A Ltd. should defer the profit of ₹ 10 lakhs.
   (d) None of the three.

3. A Ltd. sold its building for ₹ 50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is ₹ 30 lakhs. As on 31\textsuperscript{st} March, 2017, the documentation and legal formalities are pending. For the financial year ended 31\textsuperscript{st} March, 2017
   (a) The company should record the sale.
   (b) The company should recognise the profit of ₹ 20 lakhs in its profit and loss account.
(c) Both (a) and (b).

4. As per AS 20, potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would
   (a) Decrease net profit per share from continuing ordinary operations.
   (b) Increase net profit per share from continuing ordinary operations.
   (c) Make no change in net profit per share from continuing ordinary operations.
   (d) None of the above.

5. Internally generated goodwill is
   (a) Recorded at cost of generating goodwill.
   (b) Recorded at valuation done by experts.
   (c) Not recorded.
   (d) Either (a) or (b).

**Theory Questions**

1. Briefly describe the disclosure requirements for amalgamation including additional disclosure, if any, for different methods of amalgamation as per AS 14 (Revised).

2. List the conditions to be fulfilled as per AS 14 (Revised) for an amalgamation to be in the nature of merger, in the case of companies.

3. Who are related parties under AS 18? What are the related party disclosure requirements?

4. (i) What are the disclosure and presentation requirements of AS 24 for discontinuing operations?
   (ii) Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances.

**Practical Questions**

**Question 1**

A Ltd. has sold its building for ₹ 50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is ₹ 30 lakhs. As on 31st March, 2017, the documentation and legal formalities are pending. The company
has not recorded the sale and has shown the amount received as advance. Do you agree with this treatment?

**Question 2**

X Ltd. supplied the following information. You are required to compute the basic earnings per share:

<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Profit</td>
</tr>
<tr>
<td>: Year 2016: ₹ 20,00,000</td>
</tr>
<tr>
<td>: Year 2017: ₹ 30,00,000</td>
</tr>
<tr>
<td>No. of shares outstanding prior to Right Issue</td>
</tr>
<tr>
<td>: 10,00,000 shares</td>
</tr>
<tr>
<td>Right Issue</td>
</tr>
<tr>
<td>: One new share for each four outstanding i.e., 2,50,000 shares.</td>
</tr>
<tr>
<td>Right Issue price – ₹ 20</td>
</tr>
<tr>
<td>Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2017</td>
</tr>
<tr>
<td>: ₹ 25</td>
</tr>
</tbody>
</table>

**Question 3**

Swift Ltd. acquired a patent at a cost of ₹ 80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalised the cost and started amortising the asset at ₹ 10,00,000 per annum. After two years it was found that the product life-cycle may continue for another 5 years from then. The net cash flows from the product during these 5 years were expected to be ₹ 36,00,000, ₹ 46,00,000, ₹ 44,00,000, ₹ 40,00,000 and ₹ 34,00,000. Find out the amortisation cost of the patent for each of the years.

**Question 4**

Classify the following into either operating or finance lease:

(i) Lessee has option to purchase the asset at lower than fair value, at the end of lease term;

(ii) Economic life of the asset is 7 years, lease term is 6 years, but asset is not acquired at the end of the lease term;
(iii) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee;
(iv) Present value (PV) of Minimum lease payment (MLP) = "X". Fair value of the asset is "Y".

**Question 5**

AB Ltd. launched a project for producing product X in October, 2016. The Company incurred ₹ 20 lakhs towards Research. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years.

Advise the Company as per the applicable Accounting Standard.

**Question 6**

Mr. Raj a relative of key management personnel received remuneration of ₹ 2,50,000 for his services in the company for the period from 1.4.2016 to 30.6.2016. On 1.7.2016, he left the service.

Should the relative be identified as at the closing date i.e. on 31.3.2017 for the purposes of AS 18?

**Question 7**

X Ltd. sold goods to its associate Company for the 1st quarter ending 30.6.2017. After that, the related party relationship ceased to exist. However, goods were supplied as was supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transaction.

**ANSWERS/ HINTS**

**MCQs**

[1. (c), 2. (b), 3. (c), 4 (a), 5. (c)]

**Theory Questions**

**Answer 1**

The disclosure requirements for amalgamations have been prescribed in paragraphs 43 to 46 of AS 14 (Revised) on Accounting for Amalgamation. Refer Para 2.3 for details.
Answer 2

An amalgamation should be considered to be an amalgamation in the nature of merger if the specified conditions are satisfied. Refer Para 2.3 for details.

Answer 3

Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Refer Para 2.4 for details.

Answer 4

(i) An enterprise should include prescribed information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15) occurs. For details, refer Para 2.7 for details.

(ii) Para 3 of AS 24 “Discontinuing Operations” explains the criteria for determination of discontinuing operations. For details, refer Para 2.7 for details.

Practical Questions

Answer 1

The economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred. A Ltd. should record the sale and recognise the gain of ₹ 20 lakhs in its profit and loss account. The building should be eliminated from the balance sheet.

Answer 2

Computation of Basic Earnings Per Share
(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

<table>
<thead>
<tr>
<th>EPS for the year 2016 as originally reported</th>
<th>Year 2016</th>
<th>Year 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net profit attributable to equity shareholders</td>
<td>₹</td>
<td>₹</td>
</tr>
<tr>
<td>Weighted average number of equity shares outstanding during the year</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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APPLICATION OF ACCOUNTING STANDARDS

\[ \text{EPS for the year 2016 restated for rights issue} = \left( \frac{20,00,000}{10,00,000 \text{ shares}} \right) \times 2.00 \]

\[ \text{EPS for the year 2017 including effects of rights issue} = \left( \frac{20,00,000}{(10,00,000 \times 1.04 \times \frac{3}{12}) + (12,50,000 \times \frac{9}{12})} \right) \times 1.92 \approx 2.51 \]

**Working Notes:**

1. **Computation of theoretical ex-rights fair value per share**
   
   \[ \text{Fair value of all outstanding shares immediately prior to exercise of rights} + \text{Total amount received from exercise} \]
   
   \[ \frac{\text{Number of shares outstanding prior to exercise}}{\text{Number of shares issued in the exercise}} \]
   
   \[ \frac{(25 \times 10,00,000 + 20 \times 2,50,000)}{10,00,000 + 2,50,000} = \frac{30,00,000}{12,50,000} = 24 \]

2. **Computation of adjustment factor**
   
   \[ \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{25}{24} \text{ (Refer Working Note 1)} = 1.04 \text{ (approx.)} \]

**Answer 3**

Swift Limited amortised `10,00,000 per annum for the first two years i.e. `20,00,000. The remaining carrying cost can be amortised during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Net cash flows</th>
<th>Amortisation Ratio</th>
<th>Amortisation Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>-</td>
<td>0.125</td>
<td>10,00,000³</td>
</tr>
</tbody>
</table>

* Refer working note 2.

³ It has been assumed that the company had amortized the patent at `10,00,000 per annum in the first two years on the basis of economic benefits derived from the product manufactured under the patent.
| II | - | 0.125 | 10,00,000 |
| III | 36,00,000 | 0.180 | 10,80,000 |
| IV | 46,00,000 | 0.230 | 13,80,000 |
| V | 44,00,000 | 0.220 | 13,20,000 |
| VI | 40,00,000 | 0.200 | 12,00,000 |
| VII | 34,00,000 | 0.170 | 10,20,000 |
| Total | 2,00,00,000 | 1.000 | 80,00,000 |

It may be seen from above that from third year onwards, the balance of carrying amount i.e., ₹ 60,00,000 has been amortised in the ratio of net cash flows arising from the product of Swift Ltd.

**Note:** The answer has been given on the basis that the patent is renewable and Swift Ltd. got it renewed after expiry of five years

**Answer 4**

(i) If it becomes certain at the inception of lease itself that the option will be exercised by the lessee, it is a Finance Lease.

(ii) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.

(iii) Since the asset is procured only for the use of lessee, it is a finance lease.

(iv) The lease is a finance lease if X = Y, or where X substantially equals Y.

**Answer 5**

As per para 41 of AS 26 “Intangible Assets”, expenditure on research should be recognised as an expense when it is incurred. Hence, the expenses amounting ₹ 20 lakhs incurred on the research has to be written off in the current year ending 31st March, 2017.

**Answer 6**

According to AS 18 on ‘Related Party Disclosures’, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Hence, Mr. Raj, a relative of key management personnel should be identified as relative as at the closing date i.e. on 31.3.2017.
Answer 7

As per AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.2017 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist need not be reported.